1961 WINTER ISSUE

the Illinois CPA

LLINOIS SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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the Illinois CPA

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LEO V. TINKHAM

"Independence is a state of mind and we should not try to define it."

"We should not adopt a rule against competitive bidding because we have not defined competitive bidding."

The quotations are not exact, but they are the major arguments offered against proposed changes in rules of professional conduct at the recent annual business meeting of the American Institute of Certified Public Accountants. Not much was said about whether or not it is proper for a C.P.A. to express his opinion on financial statements when he has financial or other interests in the client. Neither was there much said about whether competitive bidding is good or bad.

I will not argue here whether or not the proposed rule changes are desirable. In Illinois we have adopted specific restrictions as a partial definition of independence, and we have a rule against competitive bidding without a definition of the concept. The anomalous arguments against similar rules for the American Institute did not block adoption of the rules in Illinois. The arguments must not be accepted; carried to their conclusion, they would eliminate most of our ethical standards.

It is said that independence is a state of mind. Could that not also be said of solicitation, encroachment, advertising, competitive bidding and many other unethical practices? And if we are not to define subjective concepts and are not to include anything in our rules of ethics which is not defined, don't we have to eliminate most of our rules?

President's MESSAGE

We won't go that far, but the conflict of ideas contained in the quoted arguments can and does retard progress. If the profession can agree that a prohibition against competitive bidding is desirable, the prohibition should be adopted whether or not the concept is objectively defined. I believe we all know whether or not we make competitive bids—whether or not when we submit an estimate for an engagement we expect that estimate to be a deterrent of any consequence to a billing in excess of the estimate if our time runs higher than we thought it would—whether or not our estimate was cut a little bit from our original figure so we would be low enough to have a chance of getting the engagement. Similarly, we do not need specific definitions to tell us whether or not we are engaging in solicitation or are encroaching upon a client of another C.P.A.; we know the intent behind our actions. It is said that independence and other undefined concepts of our code of ethics are states of mind. I would rather say that they are matters of heart; the mind can rationalize too easily.

To maintain an ethical standard in the profession, we must observe the readily understandable intent of our rules, abstract as they may be. We must go farther, however, and not refuse to spell out in our rules specific practices which are generally recognized as undesirable. We have taken such action in connection with certain rules—independence and advertising, for example—without proposing full definition of the rules.

At the American Institute meeting, the Illinois Society was cited for its leadership in adopting the rule limiting acceptable relationships between the C.P.A. and his client. We did not have anything to offer in the way of definition of competitive bidding although the practice has long been forbidden. I hope that the Illinois Society will continue its leadership and adopt specific rules which can be generally agreed upon and which will serve as partial definitions of the abstract ideas now expressed in some of our ethical standards.

Leo V. Tinkham

Introduction to the ISCPA Goal of Elimination of Substandard Reporting

Attack! On Substandard Reporting

y Ben D. Chaps

On June 30, 1960, the Board of irectors of The Illinois Society of ertified Public Accountants adopted ; one of their primary goals for)60–61 the activation of a program r the elimination of substandard porting. One of the approaches hich was contemplated in arriving this objective was a technical meet- g which would be devoted to a dis- ission of actual examples of sub- andard reports.

Many of us know that substandard ports are prepared by certified pub- accountants. Evidence of this is in e files of the Society, and, more kely than not, a practitioner some- me in his practice has found evi- ence of substandard reporting where has succeeded another practitioner. me reports are a matter of public cord, and these records could have en searched for examples of sub- andard reporting. However, because of a known mutual interest in this problem which we share with bankers, we elected to explore the possibility of securing their cooperation in this project.

We embarked on this venture mindful of the fact that previous attempts to secure examples from bankers had been unproductive. We were aware of the confidential nature of the banks' credit files, and we did not wish to initiate any request which would violate the privacy of the banker-customer relationship. With full knowledge of the conditions, we approached the Chicago Chapter of Robert Morris Associates which group, as you know, is the national association of bank loan officers and credit men. We outlined our concern, our program, and our appreciation of their position. We suggested that our purpose would be served, if they could get at least two examples of

EDITOR'S NOTE: These comments and the three papers and examples of substandard reporting which follow comprise a series of papers on "substandard reporting." The articles are based on papers presented at the Society's technical session on this subject in December 1960.

substandard reports from the large Chicago banks. These reports could be divested of all information of a confidential nature—we did not want any participating banker to violate a confidence.

It was very gratifying to find a deep interest in the subject of substandard reporting on the part of the Robert Morris Associates. They recognized that such a program would be beneficial to them, and they anticipated no difficulty in obtaining the desired information from their members. With these assurances we proceeded with the development of a technical meeting—an educational undertaking which we felt would make some inroads on the problem of substandard reporting.

The format of this meeting was to be based on the "horrible examples" which were received from the bankers. After considerable discussion as to the most appropriate presentation, it was concluded that the most meaningful benefits would derive from a program where appropriate background material would be developed and on which a consideration of the examples would be based. For this purpose it was decided that an educator, a practicing accountant, and a banker would be most suitable. A discussion of the examples by the panel would follow and questions from the audience would be entertained.

With this plan of meeting definitely established, outstanding panel members fitting the needs of the program were obtained. The banker was supplied by the Robert Morris Associates. The Robert Morris Associates, as they had promised, delivered examples submitted by the banks. These examples were edited for duplication, and projection slides were prepared for the ones most suitable for the purpose.

The meeting was held in the evening on December 14, 1960, with excellent attendance. Each speaker did an outstanding job in presenting the problem from his particular interest and vantage point. The examples were projected on a large screen and commentaries were offered by the panel members. The questions from the audience were numerous and provocative—evidence of the deep interest of our membership in the subject.

This meeting was our opening assault on the problem of substandard reporting. Its content merits the attention of all practicing accountants. Only a small portion of our membership had the benefit of the meeting which was held. Therefore, in the interest of greater exposure of the subject matter presented at the meeting, the papers of the principal speakers together with the examples of substandard practice submitted by bankers have been assembled for publication. If there is any validity to the view that substandard practices stem from ignorance rather than willfulness, we are hopeful that some of the causes can be eliminated through efforts such as this. The Society's attack on causes cannot expire here. It must be continued to be effective, and it deserves the consideration of each and every member.

BEN D. CHAPS is a partner in the firm of Arthur Andersen & Co., Chicago. During 1960–61 he was chairman of the Society's committee on cooperation with bankers and other credit grantors.

Substandard Reports: Their Causes, Their Implications, and Steps Necessary for Their Elimination

The Problem of Substandard Reports

By Robert K. Mautz

The expression "substandard reports" implies, first, that there are standards or requirements which the reports of independent CPAs should meet, and second, that some of us are failing to meet these requirements and are producing reports of somewhat less than the required "standard" quality. Finally, there is another implication, that something constructive can and ought to be done about this unfortunate situation.

Substandard reports could result from carelessness, ignorance, or chicanery. The consensus of this panel, I think, is that they appear primarily because of ignorance. Even ignorance, of course, is a strong charge to level against professional men, but in view of the alternatives, we prefer to consider this the primary cause.

That there are substandard reports has been brought home rather forcefully to the members of this panel. We have been supplied with selected audit reports taken from the files of a number of cooperating banks in the Chicago Loop. Some of these definitely are substandard reports. Others raise some interesting questions as to whether independent CPAs and bankers judge audit reports by the same standards. But more of this in good time. For the moment, let us turn our thoughts to the nature of the standards which audit reports are expected to satisfy, and on the basis of which they may be judged to meet or fail to meet professional requirements.

Generally Accepted Auditing Standards

Probably the first thoughts that come to mind when an auditor mentions standards are the ten generally accepted auditing standards[1] which

[1] General Standards:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, in-

are referred to in the second sentence of the scope paragraph of the recommended short-form report or opinion:

> "Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

These standards, their significance and history should be known to every practicing CPA. In order to point up a little more sharply one of the important problems of substandard reporting, however, it is desirable to inquire briefly into their background.

The present ten generally accepted auditing standards were preceded by a series of pamphlets, the forerunner of which appeared first in the *Federal Reserve Bulletin* under the title "Uniform Accounts" in 1917.[2] It was also printed separately and distributed to banking and business interests and to accountants. Essentially the same document passed through a number of reprintings and revisions in 1918, 1929, and 1936. The 1936 revision, issued by the American Institute of Accountants and titled "Examination of Financial Statement by Independent Public Accountants," received wide distribution and was considered highly authoritative by many practitioners.

As time passed, however, dissatisfaction with this statement became stronger and stronger. The complexities of modern business and the diversity of the engagements in which independent CPAs found themselves made the 1936 pamphlet less and less widely useful. Pressure from the SEC for a more definitive statement of auditing standards led first to abandonment of the 1936 pamphlet, which was allowed to go out of print, and second to a special study of auditing standards by the Committee on Auditing Procedure of the American Institute of Accountants. The results of this study first appeared as a series of papers presented at the fifty-ninth annual meeting of the Institute in 1946. Four distinguished members of the committee, Paul Grady, Edward A. Kracke, Alvin R. Jennings, and John A. Lindquist discussed the nature of auditing standards generally and of the first nine standards specifically. In 1947 the essence of their papers, together with some additional discussion, was published in booklet form under the title "Tentative Statement of Auditing Standards, Their Generally Accepted Significance and Scope."

That the proposals of the committee were well received is evidenced by action at the 1948 meeting in which the membership of the Institute approved the summarized statement of auditing standards appearing in the 1947 pamphlet. In 1949 the Institute, at its annual meeting, approved Statements on Auditing Procedure No. 23, Clarification of Accountant's Report

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quiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking. (*Generally Accepted Auditing Standards, Their Significance and Scope*, 1954, Special Report by the Committee on Auditing Procedure, American Institute of Accountants, New York.)

[2] *Federal Reserve Bulletin*, April 1, 1917, p. 70.

When Opinion is Omitted. The essence of this statement was added to the nine generally accepted auditing standards as a fourth standard of reporting and all ten were included in a pamphlet issued by the Institute in 1954 under the title "Generally Accepted Auditing Standards, Their Significance and Scope."

Some of the criticisms of the series of pamphlets culminating in "Examination of Financial Statements by Independent Public Accountants" charged them with too much specificity in their description of auditing procedures and practices. The present standards cannot be accused of this; if anything, they go too far in avoiding specifics of any kind. I have already expressed my views on this subject,[3] yet it seems pertinent to reiterate at this time my feeling that they do not give to those who need help the most any real clue to the standards which the work of independent CPAs is expected to meet. The young practitioner, the CPA working alone without the benefit of a large organization to consult with, the non-accountant reader of financial statements who has questions as to the nature of an audit, these represent the groups which most need help in understanding the real nature of the standards we must meet to avoid substandard reporting. Certainly the present standards represented substantial progress at the time they were first proposed and accepted. Just as certainly they cannot be expected to stand for all time without expansion or amplification.

[3] R. K. Mautz, "A Critical Look at Generally Accepted Auditing Standards," *The Illinois Certified Public Accountant*, Autumn, 1958, p. 12.

Other Requirements

The difficulty faced by anyone who would understand the requirements which "standard" reports should meet is further complicated by the fact that a variety of additional requirements exist, some stated rather specifically, others not stated at all. No doubt all these are encompassed by the ten generally accepted auditing standards, but because the standards themselves are couched in such general terms this is not at all clear, even to those with a fair amount of experience in practice.

For example, four of the Rules of Professional Conduct of the American Institute of Certified Public Accountants, Rules 5, 6, 13, and 19, are concerned with the performance of or reporting on audits. In addition, at the 1939 annual meeting of the Institute, the membership approved "Extensions of Auditing Procedures" which provided for direct confirmation of receivables and observation of physical inventories if practicable and reasonable in the circumstances whenever these assets are material. Note that these requirements are sufficiently important that any failure to observe them requires mention in the scope portion of the auditor's short-form report whether or not the auditor has been able to satisfy himself by other means. That same document also had a good deal to say about the disclosure by the auditor of any exceptions in his opinion and requires that: ". . . if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render

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an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.''[4]

The continuing series of Statements on Auditing Procedure express additional requirements which an auditor is expected to meet. To name but a few for illustrative purposes, one might list:

No. 25—Events Subsequent to the Date of Financial Statements

No. 26—Reporting on ''Use of Other Procedures''

No. 29—Scope of the Independent Auditor's Review of Internal Control

Finally there exists an unknown number of unspecified, unwritten requirements. For example, there is no standard specifically requiring that the independent auditor read the minutes of the meetings held during the period under examination by the board of directors or the stockholders of the company, but certainly all of us would feel that failure to do so would be a substantial breach of professional responsibility. How many similar requirements exist? Can anyone state authoritatively and with any fair degree of precision all the requirements which must be met if one is to avoid the undesired description of ''substandard''?

Here, it seems to me, is much of our problem of substandard reporting. The independent CPA is expected to meet requirements which are not clearly stated anywhere. Not only must he refer to a variety of semi-official documents and sources, he must be cognizant of responsibilities which are not stated anywhere outside textbooks and handbooks which have never been given any official recognition whatever. To repeat, the member of a large public accounting organization may have sufficient resources at his disposal to keep him abreast of these varied requirements. It is much more difficult for the lone practitioner or the member of a small firm. And how much more difficult it must be for the reader of financial statements who is not an accountant, who does not have ready access to our professional literature, and who probably does not even know that it exists. How is such a person who cannot know what our standards are to know when a report fails to meet them?

Contrasting Interests in Reports

Yet another complicating factor in this problem of substandard reporting may be discovered by contrasting the points of view which CPAs and bankers (or other readers) take with respect to audit reports. Professor A. C. Littleton once described the short-form audit report as a ''defense mechanism.'' There is at once much truth in this assertion and good reason for its accuracy. The auditor *must* view his opinion as a defensive effort as well as a means of expressing his opinion on the financial statements he has examined. First, he is in no position to insist upon a standard examination in all cases. His relationship with clients gives him very little leverage by means of which he can insist on more examination than they are willing to accept. Yet if he performs any examination at all, his name becomes associated with the

[4] Statements on Auditing Procedure No. 1, Extensions of Auditing Procedure, American Institute of Accountants, 1941.

financial statements and an unknown number of unknown third parties may look to him as responsible for any errors, omissions, or other irregularities in those statements. This has forced the auditor to spend countless hours in developing opinions which are carefully tailored to the given situation.

In the words of George Hansen: "You tell us what to write and we will tell you what we have to do; you tell us what to do and we will tell you what we have to write."[5] If the client wants a clean opinion, he must give the auditor a free hand in the performance of his examination. If the client limits the scope of the examination in any way, then he must permit the auditor to word his opinion accordingly.

In wording his opinion, the auditor looks to the extent of responsibility he may be charged with. His wording is designed to be protective, to tell what he has done and the extent of responsibility he is willing to accept. It can be no other way. I have great sympathy for public accountants and the responsibilities placed upon them by their professional work. Until they are able to insist upon a free hand in every engagement, they must continue to regard their opinions as protective.

But the banker has quite another point of view. He is not (or rarely is) an expert in either accounting or auditing. He looks to the auditor for assurance that the financial statements are reliable, that he can accept them as they are. Judging from the letters we have read, he is quite unskilled in the fine points of technical accounting terms. The rather skillful way in which an accountant may absolve himself of responsibility in a given case may escape the non-accountant reader completely. And to some extent accountants must accept a part of the blame for this. One can find references in our professional literature drawing a comparison between a CPA's opinion and the "sterling" mark on silver. This is indeed a poor and misleading analogy. "Sterling," my dictionary tells me, means that the silver is ".925 fine." I doubt very much if any of us would ever claim that our signed opinion meant financial statements were ".925 fine" or attained any other fixed per cent of accuracy. Of course the accountant's record is not all this bad. We have taken definite steps to make clear to bankers and other readers the nature of our opinions and the limitations of our work.[6] Judging from the letters supplied to us in preparation for this meeting, however, the task is far from accomplished. Let me cite an example.

The following paragraph is taken from a letter written by a representative of one of the Loop banks in response to a request for illustrations of substandard reports in its files signed by members of the Illinois Society of CPAs.

> "In one case the auditors did not verify inventories which comprised almost one half of the total assets and yet expressed a limited opinion. In the other case although an opinion was not expressed the auditors did not confirm accounts receivable or liabilities nor did they verify inventories which we feel is wholly inadequate for an audit report."

The situation in the first case is not at all clear; this letter suggests a variety of alternative situations. It is possible the auditors did not ob-

[5] In a conversation with the writer at the University of Illinois.

[6] See "Audits by Certified Public Accountants," 1950, and "The Certified Public Accountant," 1960, both published by the American Institute of Certified Public Accountants.

serve physical inventories yet were able to satisfy themselves by means of other auditing procedures, in which case qualification of the scope of the audit would be required but a clean opinion could still be given. If, however, the auditors neither observed the physical inventory nor satisfied themselves by other auditing procedures, it is doubtful that an opinion on the statements as a whole would be appropriate. An exception relating to one half the assets, it seems, would be sufficient to negate the opinion. However, it may be that the "limited opinion" described by the banker is a "piece-meal" opinion and well within the bounds of accepted reporting practices. There is little indication the banker recognized these three possibilities.

The second case is even more interesting. Judging from the banker's description, the CPA has acted in strict accordance with professional requirements, yet the banker finds the report unsatisfactory. The CPA failed to confirm accounts receivable or liabilities and did not verify inventories so he refrained from expressing an opinion. If he had expressed an opinion, we might be critical but it is specifically stated that he did not do so. Why then is he subjected to censure by the banker? I think for two reasons. First, the banker fails to understand the importance of denying an opinion. By not expressing an opinion, the auditor planned to put readers of the report on guard, to warn them to read the accompanying statements with caution; apparently he has succeeded only in irritating this particular reader. Second, the banker is not concerned with the niceties of reporting as we are; his concern is with the underlying examination. Insofar as he is concerned, this is a substandard examination, and any report based on a substandard examination is unsatisfactory.

This emphasizes the fact that bankers read our reports differently from how we write them. And we must have some sympathy for their point of view just as we expect them to have sympathy for ours. They need assurance that financial statements are reliable. This is what they understand an examination is designed to do, to put the CPA in position to give such assurances. If those assurances are not forthcoming, the examination and the report are unsatisfactory.

Classification of Substandard Reports

Based on the reports and letters made available to us, it seems to me we can detect four types of "substandard reports."

I. Reports which on their face are substandard in wording, indicating an unawareness of professional responsibilities. The following excerpt from an "opinion paragraph" is illustrative:

> "The accompanying statements are in accordance with the books and reflect the financial position at July 31, 1960 and the results of operations for the fiscal year then ended."

No doubt the auditor meant to say little more than that the statements were in accordance with the books, but when he states that they "reflect the financial position . . . and results of operations. . . ." it appears that he is taking unlimited responsibility for their accuracy. I doubt very much if he meant to do so.

Another report commences:

> "In accordance with your request we have prepared the accompanying statement of financial position. . . ."

As CPAs we all know the company "prepares" any financial statements; the auditor *examines* them. This same report closes with these words:

> "On the basis of this examination, we are in a position to report that the accompanying financial statements are in agreement with the accounts and have been prepared from the accounts in accordance with generally accepted accounting principles."

Such an "opinion" says practically nothing. Yet it might well read very impressively to a non-accountant. Has a CPA properly discharged his professional responsibilities when he has issued such a report as this? Although to us it is obviously substandard, others may have far more difficulty with it.

2. Reports which on their face appear standard but which are contradicted by details expressed in accompanying notes or comments or in subsequent reports. The accompanying extracts from two bankers' letters describe such reports:

FIRST LETTER

> "On a number of occasions, we have received an audit report which contained the standard unqualified opinion, as recommended by the American Institute, and yet in the long-form comments, the statements are made that receivables were not confirmed and the auditor was not present at the inventory-taking when in the case of receivables and inventory they constituted the bulk of the current assets."[7]

SECOND LETTER

> "The company's fiscal audit was prepared by a CPA and supported by a standard certificate with a clear opinion. There were no qualifying notes in the audit. A subsequent interim statement prepared by the same auditor reflected several sizable adjustments which were set out in a footnote. These adjustments represented approximately 50% of the fiscal net worth. The auditor was called and had no logical explanation for his treatment of these items. We stressed the emphasis placed upon standard certificates and felt these large adjustments made a very poor impression with respect to the quality of the audit and justification for a standard certificate.
>
> As a result of our first experience with this CPA firm we will not place much confidence in his future work, nor will we feel we can recommend him to others seeking accounting services."

3. Reports which appear standard on their face but which are unsupported by an adequate examination with no evidence to this effect in the report. Of course there were no illustrations of this class of substandard report made available to us, but it seems apparent from the illustrations already cited, that such reports do exist. Their harmful effects cannot be overestimated.

4. Reports which meet the requirements of the profession so far as technical wording is concerned but which are based on what we may term "substandard examinations." This subject has already received attention in this paper but another illustration may be useful. The opinion criticized by the banker is found at the close of a long-form report. The statement of scope at the beginning of the report reads:

> "Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except that we did not observe the physical count of inventory at June 30, 1960, satisfying ourselves as to the inventory by other procedures."

Note that the auditor states he has satisfied himself by other means with respect to the inventory. Although

[7] This letter also reported quite a number of reports which are enclosed in a folder showing the name of the accountant and showing the title of Certified Public Accountant but which reports contain no opinion or disclaimer or any comment to the effect that the statements were prepared without audit or anything of the kind.

he was not present for observation of the physical inventory procedures, he has satisfied himself and as long as he is willing to take the responsibility for this, professional standards permit him to offer a clear opinion. Nevertheless, the banker objected to this in the following words:

> "There is a definite exception noted here that auditor should have observed physical count of inventory, particularly since machinery stock of this company traditionally represents such a high percentage of both current and total assets. The subsequent rendering of opinion by accountants (page 12) that statements fairly present the financial condition of company at audit date is definitely questionable upon review of the scope of their inventory verification."

This illustration emphasizes the feeling apparently held by some bankers that observation of physical inventories is an absolute "must" in every "standard" examination.

Conclusions

If one pauses to take as impersonal a view of this problem of substandard reporting as possible, he finds a most difficult situation. On the one hand we have the independent CPA with (1) a variety of stated and unstated requirements to meet, (2) no power to enforce his client to accept a "standard" examination, and (3) a real and valid fear of nuisance suits and other legal proceedings.

This combination of circumstances is more than some CPAs can cope with so we find them issuing obviously unsatisfactory reports; others with a full recognition of their responsibilities have found it necessary to develop skillfully worded opinions designed to limit their professional responsibilities. On the other hand, the banker has an even more difficult task of determining the requirements which an auditor's report should meet and couples this in most cases with a limited knowledge of accounting and the niceties of the technical jargon sometimes used in opinions. He expects a standard examination with a standard report and considers anything less to be "substandard." This is the problem of substandard reporting.

Difficult as the problem is, even stating it helps us to see the nature of its solution. In the long run, the problem calls for, first, development of a more comprehensive statement of auditing standards and requirements. The present standards must be supplemented, expanded, and clearly stated in some one authoritative document. I believe firmly that such a statement is quite possible without becoming so detailed and specific as to restrict or regiment the practice of auditing. Along with this, of course must go a serious effort at continuing education for practicing CPAs. Ways must be found to give sole practitioners and the members of small firms the opportunities for interchange of ideas, the library and research resources, and the awareness of professional standards which come almost automatically to the members of the large accounting firms. A third long-range solution must be the avoidance of substandard examinations. In all honesty, we must face the fact that a skillfully worded opinion may protect the CPA but it is unlikely to aid the non-accountant reader. Certainly many of our clients benefit by services which fall well short of a complete examination. Such services should be made available in the future as in the past. But it is the service we have for sale, not our names or CPA designation. We should look forward to the day when

we sign as CPAs only "standard" examinations. This will be a long step forward toward elimination of the problems of substandard reports.

But these recommendations are for the long run. What can we do right now? First and most obvious, every CPA should make a real effort to become acquainted with present professional requirements. As divergent and scattered as such requirements are, they are available in our professional literature. There is little excuse for the practitioner who neglects his own continuing education and fails to keep abreast of current developments. Second, CPAs should make a strong effort to meet their client's bankers and to establish a working relationship with them. Except for SEC requirements, the major reason for audits consists of the insistence of bankers on audited statements in connection with loan applications. But even when a CPA serves a client in a non-audit capacity he should encourage the client to bring his banker and CPA together to the advantage of all three. A client who refuses to do this either requires further education by his accountant or must be viewed with some suspicion. Of course, this responsibility runs to bankers too. In many cases they are best able to take the initiative in encouraging the development of closer relations with their customers' accountants. Finally, accountants should take every opportunity to "educate" bankers with respect to the dangers involved in reliance on non-standard opinions. We must not assume that bankers are as familiar with the shades of meaning in audit opinions as we are. At least as much time should go into the reading of an opinion as went into its composition, and we have failed in our professional responsibilities if we do not strive to make this clear to all those who read them.

I think if we can find ways to implement these recommendations, both those for the immediate future and those suggested as long-range, we can do much to reduce the problems of substandard reporting.

Auditing Standards, Accounting Principles and Substandard Audit Reports

The Field Work and the Report

By C. C. Crumley

On the following page is presented a chart which has been developed to illustrate the interrelation, as I see it, of our "Audit Standards," "Generally Accepted Accounting Principles" and our "Report."

In the upper left of the chart you will note the three "Auditing Standards." These three are summary standards, as described in the booklet "Generally Accepted Auditing Standards" printed by the American Institute of Certified Public Accountants, categorizing ten detailed standards. The "General Standards," or the "Personal Standards" is the first group and is the foundation of our profession; from this flows our ability to perform the "Standards of Field Work," and the "Standards of Reporting." Under the "Standards of Reporting," are its various elements as found in our ordinary certificate; audit standards, accounting principles, consistency, disclosure, and our opinion.

The "Standards of Field Work" break down into three areas; Audit Procedural Standards—the accepted audit mechanics, Generally Accepted Accounting Principles, and Materiality—the professional recognition of the important from the unimportant.

In an audit, basically what we do is to (1), apply our "Audit Procedural Standards" to the client's financial matters for understanding and for verification; (2) judge the accounting principles which we observe to see that they are in agreement with "Generally Accepted Accounting Principles"; and (3) reach certain reporting conclusions taking into consideration the materiality of the matters involved.

What I have tried to portray in the chart is that in the application of our "Standards of Field Work" we filter the client's financial matters through a screen composed of "Audit Procedural Standards" and "Generally Accepted Accounting Principles," these two together as a screen, so as to reach reporting conclusions as to: Accounting Principles—their propriety, Consistency—as a statement of fact, and Disclosures—their necessity.

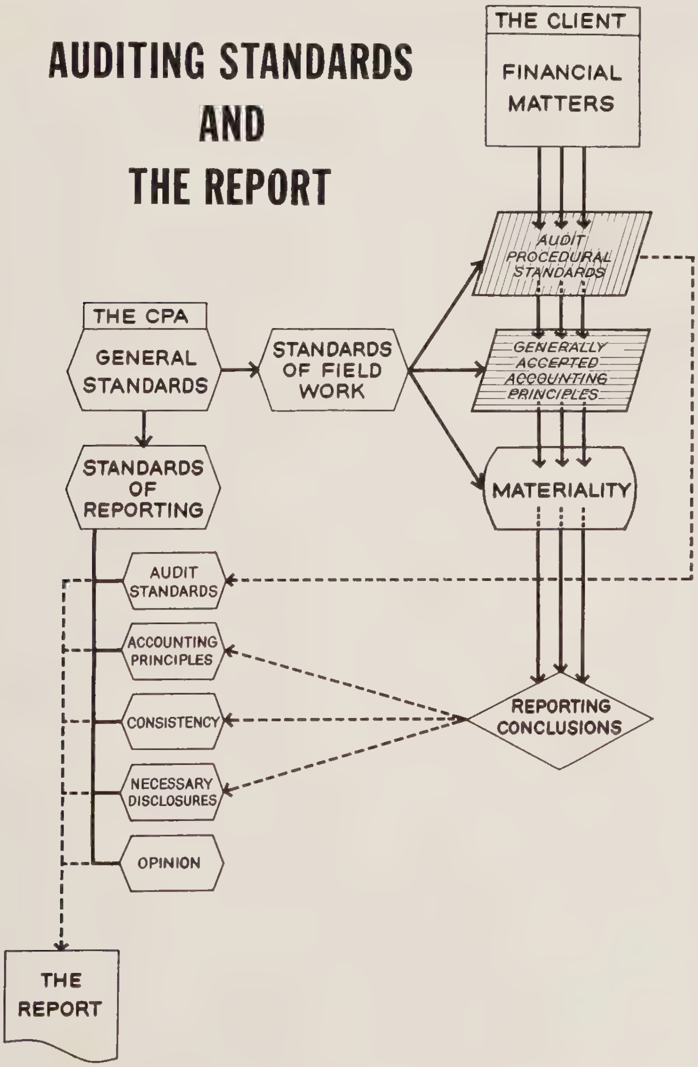
These three reporting conclusions are then combined with a further statement of fact as to the audit standards that were employed, and

then we are presumably in a position to express an opinion in a report. This basically is how I envision the application of our "Auditing Standards."

Weakness in foundation or ineptness in applying any of the links in this chain will result in reports which at best would be poor and trending toward substandard. Within this framework I think we're now ready to see some of the how's and why's of substandard reports.

Reporting and "General Standards"

The only area in which we seem to have difficulty with the "General Standards" is with the second of the underlying standards, which states that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by



the auditor or auditors." This standard gives rise to a number of complaints each year that reports are substandard—that the accountants were not in fact independent. Situations have existed where the accountant was an officer or director of a client or held a significant stock interest and still saw fit to issue an unqualified opinion—and in most instances without disclosure.

Many illustrations exist of this type of situation. A recent publication told of a CPA who was a major stockholder in a corporation that arranged for his CPA partner to issue an unqualified opinion on the corporation—and no disclosure was made of the relationship. The certifying CPA was obviously not independent, and the opinion he issued was one of the more sub of our substandard reports. No one profited when this situation was brought to light.

Fortunately, the examples with which I am familiar are out-of-state situations. Illinois, as you undoubtedly are aware, is the only state that has a forceful rule on this matter of independence. In Illinois you are not to have any financial interest in a client for which you render an unqualified opinion; nor are you to hold a title or position with the client. This rule was adopted by us in 1954 and there is every indication that other states and the Institute are to follow suit.

The SEC has also made great strides in developing guideposts of independence, and many firms have instituted policies in this area. So the evolution is definitely toward more strict interpretation of independence.

A mistake that is easily made is to assume that "Audit Standards" are static. Such is not the case; relationships that are satisfactory for today, may turn out not to be up to our standards for tomorrow. As just noted, the evolution of independence from an economic sense is one example. Another is the present evolution of the concept of independence in relationship to our so-called "write-up" work. The thinking is that no one person can be truly independent in relationship to his own work, and thus if the "write-up" work is such that the auditor is checking himself, then the auditor is not in fact independent. The SEC has taken this position, and undoubtedly the profession will be moving more in that direction in coming years.

Reporting and "Generally Accepted Accounting Principles"

As we all know, there are many "grey" areas within "Generally Accepted Accounting Principles," and to this extent the statements on which we issue our reports may not be exactly substandard, but they certainly would not be considered completely desirable products.

Some "grey" areas may have a preferred treatment, but that preferred treatment may not be obligatory. The accounting principles for pensions are a classic example of a preferred treatment, but one which has no strength. Bulletin 47 states a very desirable principle in paragraph 5, but paragraph 7 states that since this preference has not yet become generally accepted it is not obligatory. You don't have to look very far for examples of poor statements resulting from the application of this

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"grey" principle—the publication entitled "Accounting Trends and Techniques" by the American Institute of Certified Public Accountants shows several.

Pooling of interests from Bulletin 48 is another example of weak accounting principles, and one which results in a good number of poor statements.

Although our certificates or reports may not be substandard as such for these areas, the weak accounting principles to which we indicate conformity result in certificates which are equally weak. But these areas of preferred practice and weak principle, and the resulting poor reports and statements are primarily a problem of the profession as a whole. Until such time as the profession has eliminated these "grey" areas, however, we should endeavor to upgrade our individual reports in line with the broad general principles as we know them, and, as a minimum, protect the public and ourselves through full disclosure.

So, unfortunately, there will be some poor reports, which are beyond our individual ability to correct, and with which we'll have to live for some time. But where we are dealing with resolved principles, we have a different story. There basically should be no substandard reports in these areas, unless:

1. The CPA lacks knowledge of the principles involved, or
2. He is careless or does not give adequate thought to their application, or
3. He lacks personal strength—he won't stand up for his position; or take one.

A number of illustrations could be given of substandard reports in resolved areas of principle; one of the most common we see is that of overhead cost application to inventory. Some companies have excluded overhead completely from inventory cost, while others make only a token application. Very seldom do exceptions in CPA's certificates result from these understatements of inventory cost, yet reports where the understatements are material, are obviously substandard.

Reporting and "Audit Procedural Standards"

"Generally Accepted Accounting Principles" apply in most instances at the transaction level, rather than as broad general concepts. New problems create "grey" areas, and poor reports. "Generally Accepted Auditing Standards," on the other hand, apply as broad general concepts, and thus there are a minimum of "grey" areas. Each of our procedural standards is the result of some broad general standard, and any new problem will generally find some overriding auditing standard.

Thus practically no substandard reports should exist due to procedural deficiencies. If they exist, they exist because:

1. The CPA lacks knowledge of the standards, or
2. He is being careless or does not give adequate thought to the procedure, or
3. He lacks personal strength—he does not insist that the standards be followed.

Two of the most common causes of this type of substandard report are found in connection with the confirmation of receivables and physical observation of inventory. In October, 1939 the "Extensions of Auditing

Procedures'' was issued specifically stating that confirmation and physical observation were required procedures for an unqualified opinion. We still see unqualified opinions, where it is known, or later in the report it is stated, that receivables were not confirmed or that physical inventories were not observed. It is incomprehensible why this condition continues to exist.

Reporting and the "Opinion"

Lastly, let's look at the ''opinion'' as a source of substandard reporting. Certainly this isn't an unresolved area, but it's one of the most frequent causes of substandard reports.

Auditing Procedures Statement 23 was issued in December, 1949, and stated in essence that ''The report shall either contain an expression of an opinion regarding the financial statements, taken as a whole, or an assertion to the effect that if an opinion cannot be expressed, the reason therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.'' But in spite of this clear statement we still find reports that do not express or disclaim an opinion.

One report of this type came to my attention recently; it stated that an examination had been made, it told what they did, and finished with ''We will be pleased to furnish any additional information desired.'' There is no excuse for this type of report.

Another example that we still see is monthly and quarterly statements in a CPA's cover or on his stationery, with no disclaimer of an opinion. These are in violation of Statement 23.

Report Qualifications

The Canadian Institute of Chartered Accountants issued their Bulletin No. 18 in August of 1960 dealing with qualifications in auditor's reports. At the beginning of the bulletin is a summary of ''The circumstances which prevent the auditor from giving an opinion without qualification or exception.'' The bulletin indicates that these usually involve:

'' (i) Auditing deficiencies including:
  - (a) Failure to obtain essential information, and
  - (b) Limitations in the scope of the examination.

(ii) Accounting deficiencies, including:
  - (a) Failure to disclose essential information.
  - (b) Failure to adhere to generally accepted accounting principles, and
  - (c) Inconsistencies in the application of generally accepted accounting principles.

(iii) Disagreement on valuation.''

The Bulletin goes on to describe each of these items in some detail. Time doesn't permit our getting into this detail now, but I would recommend the Bulletin to you for your study. It is sufficient for this paper, however, to recognize that these causes of qualifications are generally the same as the causes of substandard reports where the specific circumstances are not properly resolved.

Substandard Reports and Professionalism

The problem of substandard reporting, apart from that caused by

"grey" areas in accounting principles, is basically one of our being a profession, or of our being a trade.

1. If we lack knowledge of our "Audit Standards" and "Accounting Principles," how can we possibly be considered by others to be professional?
2. If we are careless or don't give adequate thought to the application of the "Audit Standards" and "Accounting Principles," we don't deserve to be professionals.
3. If we lack personal strength, we aren't professionals.

Substandard reports by their mere existence injure the prestige of the entire profession and act as a deterrent to our future growth. Obviously it is to the best interest of each of us to follow the leadership that the profession provides to improve our "Audit Standards," and to apply all of our professional skills to eliminate reports that could in any way be referred to as "substandard."

Is The Present Income Tax Law Equitable?

" 'The time has come,' the Walrus said, 'to talk of many things, of shoes and ships and sealing wax, of cabbages and Kings.' " If Lewis Carroll were to write *Alice in Wonderland* today he most certainly would add "income taxes" to the Walrus' list of things to talk about. For what is more fantastic than today's income tax law? Just as Alice popped down an innocent looking rabbit hole only to find herself in a strange bewildering land of fantasy—so did American taxpayers some 40 years ago start down what appeared to be a simple path of taxation, only to find themselves lost in a labyrinth of rules and regulations, vainly attempting to explain a code distorted by a myriad of special exemptions, provisions, credits and deductions.

. . . Today with the 1954 Revenue Code we have a law requiring 929 pages, a law so complex, so full of loopholes and ambiguities that it has taken over three years to write regulations interpreting it. Who can deny that we have reached the ultimate in fantasy land, or, as Alice might have expressed it, we have a severe "code" in the head?!

If the income tax is to survive it must be simplified; it must be reduced to a code and regulations that are easily understood by any uneducated layman; and above everything else, *all, absolutely all,* of the special provisions, exemptions, deductions and credits must be taken out of the Code or reduced to such a bare minimum that all taxpayers can again respect the income tax law.

Now who is going to do all of this reforming of the present tax code? Certainly not the privileged groups; certainly not labor unions or trade associations, and most certainly not the Republican or Democratic party. It is going to be done by people like yourselves who may even have to give up certain privileges that you have under the present law; people like yourselves, who can foresee that major surgery is necessary within the next few years so that chaos does not overtake our system of taxation.

MALCOLM REED
Taxes—The Tax Magazine
July, 1961

Confidence in the Accountant Is a Necessity in the Credit Granting Function

Bankers' Problems with Respect to Financial Reports

By F. W. Burnham

You realize that it is axiomatic for the banking profession as a whole to respect highly the Illinois Society of Certified Public Accountants including, among many other achievements, its yeoman work in maintaining and, where possible, improving standards of professional excellence. The previous papers have covered in an excellent manner the accounting aspects of substandard reports. Therefore, to avoid an anti-climax, my remarks will be confined to a few elementary statements suggesting how the poor downtrodden banker is almost completely at your mercy.

Of course, every banker has some accounting background. We even have people originally fairly well trained in accounting on our staffs. In fact some are members of the Society. On the other hand, we should recognize that lending officers of banks must be regarded as laymen in your hands. It is the constant exploration and study of professional principles which distinguish professions like your own as well as, for example, law and medicine. As you have frequently found in your contacts with financial personnel an individual becomes rusty when he is simply on the outside looking in. Thus, it's easy to understand how subtle phraseology may be misleading to the layman. In fact, as a wise, old business friend recently commented: "It is far better to know nothing than a lot of stuff that isn't so."

Yet, every bank officer obviously needs to keep up to date on the financial position of each of his depositors. In addition to the reason that instantly comes to your mind, namely, the extension of credit, the banker is naturally one of the first sources of general financial advice to his depositor and is also, even in the case of a non-borrower or non-consultant, the first place given as a reference to his depositor's standing. All three, reference, counsel and credit constantly recur.

Therefore let's spend a few minutes considering three points, such as:

first, standard credit analysis; second, how bankers feel the accountant functions; and, third, confidence in both the depositor and his accounting advisor. Since your work is generally with businessmen as such rather than consumers, let us confine our discussion to the commercial field.

Standard Credit Analysis

Credit analysis is essentially simple. The only problem is having the facts straight and all the essential facts. The scope of any analysis is twofold: first, the amount of money involved; second, timing of repayment. Parenthetically, sometimes a depositor forgets the latter, asking a common question: "Well, I'm good for it, aren't I?" But it doesn't take much reflection to show that the ease of bank lending is based upon precise receipt of repayment, not only as evidence that the borrower has his affairs under pre-conceived control, but to give the lender the expected opportunity to appraise performance, and properly to distinguish a loan from permanent capital.

To touch another aspect, credit grantors, actual or potential, look to what you've heard called "the four C's of credit." These are, of course: character, capacity, capital and conditions. They all apply regardless of which of the main types of credit may be under consideration. However, just for the record, you will recall that typical commercial loan situations fall generally into one of two categories. The traditional one is the advance that is to be repaid through a seasonal liquidation of assets or the performance of a specific contract. The second is now equally familiar although it first started to become prevalent in the commercial banking field of this country about twenty-five years ago. That's term credit, repayable by operating cash throwoff, including unexpended depreciation or depletion plus undistributed earnings. You well know that neither type of loan can be analyzed without both balance sheets and operating details. In either case, moreover, the traditional four C's apply.

Some might ask how the accounting profession is responsible for these criteria other than the ones referred to as capital or, perhaps, capacity. But when you recall the extensive use of comparative figures, both to determine the internal soundness of an individual enterprise and contrast its performance with both absolute standards as well as its peers in the trade, you can readily see that a borrower's financial reports may serve as continuing testimony for any category of performance. Furthermore, you recognize that a loan isn't simply extended and forgotten. Not only does a credit grantor advance money with the expectation of getting it back, but the banker wants to be of permanent service to the same depositor. Thus, a recurring study of regular series of reports is one of the prime tools in the proper administration of a deposit relationship.

Bankers' Reliance on Accountants

As to our second topic, the bankers' reliance on the accounting profession doesn't lend itself easily to brief cataloging. However, at the risk of omitting some important items, we can review a few. Fundamentally, notwithstanding the fact that the lending officer is sufficiently interested in his customer to make frequent personal visits, you agree that that officer certainly lacks the unique ability of the

accountant to go behind the figures, not only with ready access to facts for the exercise of judgment, but consistently and on every statement date. Furthermore, the lending officer naturally expects each customer to have a thoroughly adequate system of internal control. Even a small business needs to know where it is, before it can determine where it is going. How can this be achieved without competent professional accounting advice at the outset and regular review thereafter? In addition, the broad business experience of the accountant is a constant source of counsel to his client. Now, particularly, near the end of the year, none of us can forget that a high proportion of our own income, to say nothing of 52% of even the medium-sized corporation's net, will go for taxes. Who can better provide guidance than the qualified accountant? Taking systems, general business counselling, and taxes, together, who but the accountant, again, can insure the maintenance of consistency plus a sophisticated evaluation of any external influences that might not otherwise be reflected in a client's accounts? Yet the resulting altered valuations, establishment of reserves, plus notes on contingent liabilities must be intelligible to some reader. In the absence of that welcome but rare event, an authorized personal interview with a client's accounting advisor, the actual financial reports are the only evidence that the banker sees. Moreover those reports are a permanent record often studied again and again.

Confidence

Finally, therefore, it's hardly necessary to suggest that confidence in both the depositor and the accountant rests to a considerable extent on what the banker sees. Since a common yardstick of performance is the fiscal year, such evidence is automatically the financial report. It's unnecessary to examine right now the varying preferences from time to time, for long or short form reports, although it's an interesting topic. However, in either case the appropriateness of the accountant's expressed opinion is a prime object of scrutiny. You don't need to be assured, by the way, that the average banker realizes that despite an unqualified opinion, an auditor is not holding himself out as an appraiser. Nevertheless he does feel that the accountant has an undeniable responsibility for providing reliable reports in clear and understandable language.

In spite of the good job done by both the American Institute of Certified Public Accountants and the Illinois Society, in maintaining the standards of their own profession on the one hand and, on the other, trying to keep credit grantors up to date on modern accounting practice, enough unsettled areas exist, new problems arise, while new people constantly enter both the accounting profession and financial fields. Bankers may not often be the paying client, but they appreciate being recognized as a large scale consumer of accountants' visible product.

Therefore you can't blame credit grantors for feeling wounded when any evidence of non-standard reporting occurs. It's hardly necessary to suggest that variations from standards attack: (1) usefulness of reports for analytical purposes; (2) bankers' confidence in the character of other

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services provided by such a professional advisor, and (3), not to anyone's surprise, indirectly reflects upon the character of the accountant's client. Therefore, can there be any doubt as to the validity of criticizing, however infrequently encountered, substandard field work or reports, evasive language by accountants or the failure of CPA's to understand bankers' limitations in following technical language? Finally, you must realize that there exists an occasional risk that possibly unauthorized personnel among your clients might inadvertently remove a sheet from a report, such as a Balance Sheet, so that it might be read out of context. This suggests the prudence and courtesy of placing on every page of figures (as many firms do) a notation to the effect that the accompanying notes, comments or supporting data are an integral part of the statement.

I am happy to say that we don't often observe deviations from accepted standards of either reporting or field work. But the banker is so conscious of his dependence on your profession that it doesn't take much imagination to realize the loss he feels from any such incident. For example, the Robert Morris Associates has a booklet "Financial Statements for Bank Credit Purposes," originally issued in 1951, that we give appropriate depositors. It's intended, not as a guide to auditing procedures but as a tool to impress upon the customer (1) that he needs regular CPA advice, and (2) that a comprehensive engagement is in his interest. Thousands have been distributed. Thus uniformly high standards in the profession will help us serve our depositors better. In thinking of your profession I'm again reminded of my wise old business friend's expectation of the U.S. President: "a combinaion of Moses, Demosthenes, St. Peter, Houdini, and Santa Claus."

In conclusion, we have touched briefly on the field of credit analysis, bankers' appreciation of the broad scope of the accountants' professional functions, and the question of the degree of confidence in both accountant and client created by the visible evidence.

We've been speaking only in generalities, however. On the following pages we can see what examples your committee's research has unearthed.

Examples of Substandard Reports

Exhibit 1

Cicero 50, Illinois.

To the Members of the Board of Directors:

In accordance with your request, we have prepared the accompanying statement of financial position of

....

(an Illinois corporation)

as of October 31, 1959, and the related statements of stockholders' equity and of income and expense for the fiscal year then ended.

We did not confirm either the accounts receivable directly with customers or the liabilities directly with the creditors; neither did we verify the quantities and unit prices of the inventories. Therefore, we are not in a position to express an opinion upon the financial statements.

Our examination did include a review of the accounting procedures of the corporation and an examination or testing of the accounting records to the extent that we considered appropriate in the circumstances. In addition, we analyzed all account balances in the statement of financial position and tested many of the accounts in the statement of income and expense.

On the basis of this examination, we are in a position to report that the accompanying financial statements are in agreement with the accounts and have been prepared from the accounts in accordance with generally accepted accounting principles.

Very truly yours,

Exhibit 2

"We have examined the balance sheet of ...., consolidated with its finance subsidiaries, as of September 30, 1959, and the related statement of consolidated income and surplus for the fiscal year then ended. We did not examine the balance sheets and related statements of income and surplus of the four .... subsidiaries and one .... subsidiary that are included in the consolidation. For each of these corporations we accepted the report of examination of other independent Certified Public Accountants. The investment value and net earnings of the insurance subsidiary were accepted as shown by the company. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and related statement of income and surplus present fairly the consolidated financial position of .... and its subsidiaries as of September 30, 1959, and the results of their consolidated operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

Exhibit 2A

Banker's Comment on Exhibit 2

This certificate was prepared in connection with an audit of a small loan company. The investment value (shown at book value) of the insurance subsidiary was in excess of $500,000; the net earnings of the subsidiary were not given, but they were consolidated with other subsidiaries.

Exhibit 3

Opinion

In our opinion, the accompanying balance sheet and the related statements of income and surplus present fairly the financial condition of .... as of June 30, 1960 and the results of the Company's operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted,

Exhibit 3A

Banker's Comments on Exhibit 3

Auditor has rendered opinion on company's statement. Scope of examination qualifies verification of inventory to other procedures than observation of the physical count at fiscal date. In addition, a certificate was obtained from company management certifying that inventories were taken by actual count and valued at lower of cost or market, with due provision for all unsoluble and obsolete machinery.

Audit report values all inventory at $263,000 and all current, including $241,000 of used machinery (company is dealer in new and used machinery). This stock on hand represents 511 days of net sales or 705 days of cost of sales.

There is a definite exception noted here that auditor should have observed physical count of inventory, particularly since machinery stock of this company traditionally represents such a high percentage of both current and total assets. <u>The subsequent rendering of opinion by accountants that statements fairly present the financial condition of company at audit date is definitely questionable upon review of the scope of their inventory verification.</u> (Underscore added)

Exhibit 4

Officers and Directors
Chicago 31, Illinois

We have examined the books of account and record of ....INC. for the fiscal year ended July 31, 1960. In connection therewith, we inspected or tested accounting records of the company and other supporting evidence, without making a detailed audit of all of the transactions. We requested no information from outside sources and confined our verifications to information available at your office.

The accompanying statements are in accordance with the books and reflect the financial position at July 31, 1960 and the results of operations for the fiscal year then ended.

The Inventory of Merchandise at July 31, 1960 represents a physical count taken by responsible employees of the company. We have accepted the valuation without any verification.

The attention of the reader is called to the fact that a partner of this firm is financially interested in the subject company.

Based upon such examination, we present the Exhibits and Schedules,

indexed on the following page, which comprise this report.

Respectfully submitted,

Exhibit 4A

Banker's Comments on Exhibit 4

This report of 7/31/60 and previous report of 7/31/59 were prepared by a CPA firm who confined their verifications to information available in client's office. Inventory valuation was accepted without verification and no information was requested from outside sources to confirm any items appearing on statements.

The accountants state that a partner of their firm is financially interested in the subject company. While no standard certification is presented, the body of introductory remarks contains the following:

"The accompanying statements are in accordance with the books and reflect the financial position at July 31, 1960 and the results of operations for the fiscal year then ended."

A comparison of 7/31/60 and 7/31/59 Balance Sheets leaves several unexplained significant changes between both year ends. Nor does P & L for year ended 7/31/60 reflect any explanation of these following items:

	7/31/59	7/31/60
Investment in Subsidiary	$ 68,139.	$166,359.
Advances to Subsidiary	281,220.	—0—
Loans Payable—Officer & Others	491,300.	—0—
Paid-in Surplus	—0—	347,047.

Exhibit 5

Board of Directors

We have examined the statement of financial position of .... as of .... Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement of financial position presents fairly the financial position of .... at .... in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Certified Public Accountants

Exhibit 5A

Banker's Comments on Exhibit 5

In this situation the auditor speaks of having examined the "statement of financial position" and proceeds to render an opinion only on the statement. It appeared to us that we had an audit limited to the balance sheet only, but the reference to the statement of financial position seemed to give a broader application to the coverage than intended.

Ordinarily, a certificate would give reference to the effect that "our examination did not include the results of operations for the year ended." In discussing this with the auditors, they verified that this was a limited engagement. It was their feeling that by referring to the balance sheet alone there was no necessity to even mention the statement of operations. It is difficult to see how the firm would certify the balance sheet with a clear opinion and yet not cover the intervening profit and loss statement.

The reports presented here were submitted by Chicago banks at the request of the committee on cooperation with bankers and credit grantors.

Apparently the auditors satisfied themselves that the net profit was proper, so they felt justified in reconciling net worth.

This situation, of course, points out that any deviation from the language of a standard opinion should act as a warning signal. It was our feeling that this was a very misleading practice for an auditor to follow. (Underscore added).

Exhibit 6

"We have examined the balance sheet of .... as of May 31, 1960 (Exhibit A) and the supplemental schedules pertaining to financial position and cash balances as of that date .... Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures, in relation to the balance sheet only, as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and supplemental schedules pertaining thereto .... present fairly the financial position of the Company at May 31, 1960, in conformity with generally accepted accounting principles consistently applied.

Our examination did not comprehend the summaries of income and surplus .... or the supplemental schedules relating to the results of the Company's operations ...., and we do not express an opinion concerning them."

Exhibit 6A

Banker's Comment on Exhibit 6

This certificate was prepared in connection with the auditing of a general insurance agency which shows gross commissions in excess of $1,000-000.

Exhibit 7

In reply to your letter of September 20 in which you asked for samples of some substandard reports received from members of the Illinois Society of CPA's, I am submitting the following two conditions which I believe meet with your request:

1. On a number of occasions, we have received an audit report which contains the standard unqualified opinion, as recommended by the American Institute, and yet in the long-form comments, the statements are made that receivables were not confirmed and the auditor was not present at the inventory-taking when in the case of receivables and inventory they consisted the bulk of the current assets.
2. We have received quite a number of reports which are enclosed in a folder showing the name of the accountant and showing the title of Certified Public Accountant, but which reports contain no opinion or disclaimer or any comment to the effect that the statements were prepared without audit or anything of the kind.

Exhibit 8

Regarding your letter of September 20, listed below are two examples as requested:

1. Major errors—A footnote to the balance sheet indicates that the bank loan is collateralized by receivables and inventories. In addition, we held as collateral to part of the bank loan a chattel mortgage on the major portion of company's fixed assets to which no

reference was made in the footnotes.

In the current assets section of the balance sheet under the caption accounts receivable was an item "Affiliated Companies—$18,366.05." In reviewing the balance sheet items with the management we learned that one affiliate owed the company $26,000, while the company owed another affiliate approximately $8,000 and the auditor netted these two amounts. Minor errors, of which there were several, indicated mislabeling of certain columns of figures, labeling the net profit as gross profit, and errors in spelling.

2. Auditors' certificate is qualified by a paragraph stating that the individual listed first on the accountant's letterhead has been employed on a full-time basis by the company as Controller which, of course, removes the independent attitude of the report.

Exhibit 9

The company's fiscal audit was prepared by a CPA and supported by a standard certificate with a clear opinion. There were no qualifying notes in the audit. A subsequent interim statement prepared by the same auditor reflected several sizable adjustments which were set out in a footnote. These adjustments represented approximately 50% of the fiscal net worth. The auditor was called in and had no logical explanation for his treatment of these items. We stressed the emphasis placed upon standard certificates and felt these large adjustments made a very poor impression with respect to the quality of the audit and justification for a standard certificate.

As a result of our first experience with this CPA firm we will not place much confidence in his future work, nor will we feel we can recommend him to others seeking accounting services.

Results of a Survey Taken at the ISCPA Annual Meeting, May, 1961

Substandard, Subconscious, or Sublime

A portion of the program at the annual meeting of the ISCPAs in Springfield in May, 1961, was devoted to the topic of substandard reporting. At this session Ben Chaps, chairman of the committee on cooperation with bankers and other credit grantors, presided, while Ray Hoffman and Larry Seidman discussed programs undertaken in other states to combat the substandard reporting problem. A questionnaire was distributed at this session to get an indication of the thoughts on this subject by those present at the session. The following paragraphs present the tabulated results of this questionnaire survey.[1]

1. Of those returning the questionnaires 122 were CPAs and 13 were otherwise employed:

a. CPAs outside Chicago	65
b. CPAs inside Chicago	57
c. Officer or employee of retail, wholesale, or manufacturing company	7
d. Professors	3
e. Bankers	1
f. Others	2
Total	135

2. Of the 122 CPAs, 44 identified themselves as representing a small firm, 39 as from a medium-sized firm, and 39 as from a large firm.

3. The response to the question, "Do you believe that substandard reporting by ISCPA members is sufficiently common to justify some particular Society activity?" was as follows:

a. Yes	88
b. No	2
c. Do not know	45
Total	135

4. Four possible types of action were presented as choices to those receiving the questionnaire. The four types of action were not presented as alternatives, but each was presented as a possible avenue for ISCPA action. Responses to these types of action were:

a. Should the Society consider a survey designed to ascertain the nature and extent of substandard reporting by a co-operative program with banks, a plan undertaken by the Texas Society?
Yes 87 No 34

b. Should the Society consider a survey designed to ascertain the nature and extent of substandard reporting by sending a questionnaire to members, a plan tried in California?
Yes 70 No 39

c. Should the Society consider voluntary participation programs designed to minimize substandard reporting by having members offer consultation service, a plan adopted in Oregon?
Yes 98 No 21

d. Should the Society consider voluntary participation programs designed to minimize substandard reporting by

[1] The questionnaires were tabulated and summarized by the Editor, who assumes full responsibility for the results as presented. Likewise, any interpretive comments contained herein are the responsibility of the Editor.

having members offer to review working papers and reports, as has been done in Michigan?
Yes 26 No 71

5. The last set of questions presented several other possible courses of action which the Society might consider. Again each individual was asked if he felt the possibilities stated were desirable courses of action for the Society to follow. The possibilities and responses were:

a. Large seminars or technical meetings for the purpose of reviewing auditing standards. Yes 49 No 55
b. Small group meetings devoted to a discussion of auditing standards (and attendant problems.) Yes 101 No 20
c. Preparation of a model set of reports to which all Society members would have access. Yes 83 No 30
d. Creation of a consulting service to assist members on questions of auditing standards and related matters. Yes 98 No 11
e. Require all members either to report examples of substandard reporting (deleting all identification except accountant's name) or to discuss differences with CPA responsible for report. Yes 60 No 48
f. Publicize the existence of an advisory service which bankers and credit grantors could avail themselves of on matters of substandard reporting. (Reports to be discussed would be devoid of identifying material—sole purpose to provide petitioners with professional analysis.) Yes 88 No 24
g. Encourage the participation of bank examiners in disclosing examples of substandard reporting (contained in credit files) to bankers. Yes 76 No 39

In addition each questionnaire provided a space for members to state their comments or suggestions. While no effort has been made to analyze those comments that were received or to tabulate them in any manner, several comments are presented below as examples of the additional thinking of some respondents to the questionnaire.

"I believe that the profession should police itself. While banks may be called upon to assist in discovering substandard audits, the profession must be prepared to take some positive action of its own."

"Our 'policing' and housecleaning should be done by us from within our ranks—not by banks, etc. and other outsiders."

"Let us try first to put our own house in order before we let the bankers and other outsiders into the act."

"The CPA's should do themselves whatever it is decided to do. Bad for public image to ask outsiders to do what we should do ourselves. We should judge ourselves."

"The problem is not primarily ours—it is that of banks and credit grantors, and we should think of it that way—ours is a selfish interest in the problem(justified, nevertheless). Our approach should be to make the banker, etc. aware of their problem, and offer such assistance as they will use in helping them solve it."

"Use *Illinois C.P.A.* to publicize horrible examples, etc."

"Publish annually a volume of actual opinions, on a non-identification basis, wherein unusual problems were present. Such opinions to be submitted by member firms on a voluntary basis."

"Urge education of bankers with respect to standards, possibly through furnishing of courses by American Banking Association."

"Most banks, even large banks, accept substandard audit reports—with no reservations—clients are not told that reports are substandard. Bank-

rs should adopt some policy regarding the acceptance of such reports.

"Have bankers report to an Illinois CPA committee the names of the CPA's who issue substandard reports."

"There should be some mechanism whereby a member who has issued a substandard report (and found by one of our members or by outside agencies) would be called in for a discussion of his problems, not with discipline in mind, but assistance to him."

"Substandard practices are normally performed by practitioners that are non-members or absent from meetings. Suggest a mailing program calling attention and demanding correction."

"Believe our efforts in educational effort (meetings, literature or otherwise) should be directed to *all* Illinois CPA's in public practice (not merely our members). It is this segment which I believe needs attention and through such efforts may even be converted to membership."

Summary

Based upon this survey the following observations appear to be appropriate:

1. The majority responding to the questionnaire feel that the ISCPA should be sponsoring some activity to minimize substandard reporting.

2. A program encompassing the review of working papers and reports by Society members does not appear to be desirable.

3. Large seminars or technical meetings may not be the best vehicle for reviewing audit standards.

MORE GOVERNMENT IN BUSINESS

Specifically, I predict that federal activities will undergo the following changes in the next few years:

1. More goods and services will be bought by government.
2. Government will extend support for science.
3. Government will continue to expand as an entrepreneur.
4. Federal regulation of business activity will be extended.
5. Government will continue to "promote" major industries.
6. Business will receive encouragement to invest abroad.
7. Government will persist in protecting the underdog.
8. Government will steadily promote economic stability and growth.

John J. Corson, "More Government in Business,"
Harvard Business Review, May-June 1961

The Benefits and Pitfalls of a New Tool for Achieving Tax Equity

The Private World of Subchapter S

By Edward H. Robertson

In the summer of 1958, Congress in an action similar to those of many previous summers, came through with a heterogeneous tax bill that eventually was given the name of the Technical Amendments Act of 1958. This was a so-called bobtail bill in which a number of proposed amendments to the Internal Revenue Code were grouped by the House Ways and Means Committee into one bill that was rushed through Congress in the closing days of the session. A somewhat unheralded segment of this bobtail bill amended the Internal Revenue Code by introducing a new group of sections referred to collectively as Subchapter S.

The new subchapter was greeted with considerable furor, principally by the reporting services. Here, we were told, was a new device which would go a long way toward solving everybody's tax problems. The grandiose claims made for our new subchapter, had they been made for a new breakfast food would probably have called down the wrath of the Federal Trade Commission and the Better Business Bureau.

With all the publicity given to the extravagant predictions of tax avoidance to be accomplished under the new subchapter, it is somewhat surprising that Congress did not promptly repeal it.

In the two years that have elapsed since the enactment of the new subchapter, experience has shown that while it is a useful device in appropriate circumstances, it has not provided any serious impact on the national revenue. It has, however, proved to be a handy additional tool to be used by some taxpayers to help achieve an equitable tax position.

It certainly has not been ignored. In the statistics that have been published, it is reported that for the year 1959 approximately 60,000 business organizations filed returns under the new subchapter.

If Subchapter S has not accomplished all that those who took up its cause on enactment had hoped for there is probably one principal explanation. Since the advent of high tax rates, the American business community has been extremely tax conscious. With careful planning the principal tax advantages now available under this subchapter could usually have been achieved in somewhat modified form prior to its enactment.

For instance, when Subchapter S arrived, it was pointed out that under the new subchapter a partnership could now incorporate and, nevertheless, have its income taxed to the partners. If this were done the partnership and the partners could obtain the tax advantages available to employees of the corporation. The partners could participate in such things as pension and profit sharing plans, where money could be set aside presently in trusts or insurance contracts for their later benefit, and also in such things as group life and health insurance. In my experience, where such benefits were of importance to members of partnerships, serious consideration had previously been given to actually incorporating, and in many cases this had already been done.

While the Internal Revenue Code does place a limitation of reasonableness on salaries paid, nevertheless there is a great deal of flexibility in the matter of compensation so that once incorporated the business could, in effect, dispense most of its income in the form of compensation to those who had previously been partners. That portion of the income which was not paid out in compensation was retained and taxed to the corporation, and in effect represented, as far as the partners were concerned, a tax-paid savings account. With stock buy-out agreements it was a part of prudent estate planning that when one of the partner-stockholders died, his estate could have this stock redeemed at a formula price, so that there was only one income tax paid on the income retained in the corporation. There were many partnerships, of course, which had not incorporated because, under the laws of the state or the ethics of their adopted profession, incorporation was forbidden. Subchapter S offered no solution to this problem.

Description

When it arrived, Subchapter S created a taxable entity with hybrid characteristics. It has been described as a corporation taxable as a partnership, although there are obvious exceptions to that comparison. The reporting services struggled for a name for the new entity and their efforts were not completely triumphant. One service liked Pseudo-Corporation. Another one thought Tax Option Corporation was appropriate. The Code referred to it as a Small Business Corporation, but this wasn't particularly helpful because in the same Act there was created a different species of corporation (a corporation whose stock was endowed with certain characteristics—such that a loss on a sale by an investor could give rise to an ordinary loss) and this type too was labeled as a small business corporation. It appears that the most descriptive title that can be applied, at least when discussing the situation with people who are generally familiar wih a rudimentary understanding of tax laws, is simply Subchapter S Corporation.

A Subchapter S Corporation is in effect a corporation which is taxed substantially as other corporations with one major difference. It gets a deduction for dividends and for constructive dividends, and its stockholders are required to pay a tax on its dividends and its constructive dividends, and can claim a direct benefit from its losses.

Under Subchapter S the stockholders pay the tax on the corporation's income, and accordingly the statute

provides special treatment for two specific types of income—negative income—that is, a loss—and capital gain income. Under the subchapter, losses of the corporation are deductible by the stockholders, limited, however, to their basis for their investment in the company. Similarly, capital gains of the corporation are taxable as capital gains to the stockholders whether or not distributed. Here, however, the conduit theory ends. Such tax attributes as percentage depletion, dividends received, and nontaxable interest lose that status before they can be passed to the individual stockholders.

An interesting feature of Subchapter S is the attempt to limit it to closely-held companies. The Subchapter S election is available only to companies who have not more than ten stockholders. Originally if a husband and wife owned stock jointly in a company they were considered to be two stockholders. Subsequently, in a magnificent gesture toward the sanctity of the American home, the Code was amended to provide that if a husband and wife held stock jointly, they would constitute, in the aggregate, only one stockholder. But, nevertheless, the limitation on the stockholder ownership remains very small. Moreover, a Subchapter S company must be an operating company as opposed to an investment company. If more than 20 per cent of its income is of the investment type it is not eligible to report and have its income taxed under this subchapter.

This is in contrast to other types of conduit corporations recognized under the Internal Revenue Code where the stockholders are taxed on the corporation's income. For instance, under Subchapter M of the Internal Revenue Code, certain investment companies are treated as conduits for passing income to their shareholders. The application of this subchapter, however, is limited to regulated investment companies, which means companies which are registered under the Investment Company Act of 1940. A company can not be registered under this act unless it has at least 100 stockholders, and offers shares to the public. Hence, this paradox. Operating companies, in order to have their income taxed to their stockholders, have to be closely held. Invesment companies must be widely held in order to so qualify.

Recently the conduit concept was extended by statute to real estate entities which could adopt the status of a real estate trust and have the real estate income taxed to the shareholders or trust owners. The real estate trust taxation route is not available, however, unless there are at least 100 participants. Just why operating companies must have limited ownership in order to achieve this treatment has never been very thoroughly explained, but if a company is to qualify under Subchapter S, its stockholders must take steps to prevent widespread stock ownership.

When Subchapter S is Desirable

Experience since the enactment of Subchapter S is concededly quite limited. Nevertheless, a pattern has developed to indicate some of the typical situations where Subchapter

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S might be the appropriate route to follow. One instance where it can be effective is for a new company. In fact, considerable support could be mustered for the propostition that every new company, whose initial stock distribution brings it within the qualifications, should file an election to be taxed under this subchapter. Part of its attractiveness in the early years stems from the fact that new corporations frequently start out incurring losses as they incur the extra start-up expenditures necessary to achieve a place in a competitive economy. Under Subchapter S these losses may be picked up and deducted on the separate income tax returns of the individual stockholders. If these stockholders have other sources of income, the losses produce an immediate tax benefit.

To achieve an effective election, it must be made during the first month of the taxable year. For a new corporation, it has been ruled that the election must be made within one month (30 days) from the date its first year begins—presumably the date of its charter.

If toward the end of the first fiscal year it appears that the losses will not produce a tax benefit in the hands of the stockholders, or, better still, that the corporation is making money, there are several devices available which can be invoked to disqualify retroactively the company's election. Additional stock may be distributed in order to raise the number of stockholders above the magic number of ten. Or, one of the stockholders might make a gift of the stock in trust for another member of his family, since the ownership of stock by a trust automatically disqualifies the company from Subchapter S. Another method of disqualifying is to acquire a subsidiary company, and it appears from a literal reading of the Code that the mere formation of a subsidiary would be enough to bring about disqualification. The declaration of a preferred stock dividend would disqualify the company as a Subchapter S company since by definition it can only have one class of stock outstanding. The procedures available to disqualify a company under Subchapter S are so plentiful and so readily accomplished that it can only be concluded that it was intended by Congress that it should not be too difficult to escape from under the Subchapter S umbrella. Consequently, any new company can elect under Subchapter S with the assurance that if, toward the end of its first year, it appears that the subchapter is no longer appropriate, the election can be nullified.

The regulations require that if the election is terminated the District Director must be notified within thirty days. Since termination is by statute, it is difficult to see what the effect of this regulation is. There is no specific penalty for ignoring it—indeed, the loss of Subchapter S status is, in context, a penalty for having violated one of the stock ownership or operating rules.

The 65th birthday is probably the most significant birthday we have in our status as taxpayers, and it may be important in the Subchapter S picture. Suppose a man is self-employed. If he goes on working after his 65th birthday his earnings are subject to social security tax and he is denied social security benefits. If he should incorporate his business, however, elect under Subchapter S, and not put himself on the corporation payroll, the subchapter would convert his earnings into dividends. He

would, therefore, have no self-employment income, and no self-employment tax, and would be able to collect social security benefits.

The same opportunity is available to the employee-owner of a closely-held corporation. In this situation the subchapter provides that the Commissioner may reallocate the income to give recognition to personal services, but the income is still considered to be dividend income.

In practice, where this situation has come to the attention of social security officials, it is understood that they have refused to approve benefits for a Subchapter S stockholder who performed services for the company without compensation and received income distributions. There appears to be no statutory authority for such a refusal and it seems likely that unless the law is amended the issue will be litigated.

Another situation in which Subchapter S is frequently appropriate involves the inactive shareholder. Let us assume for instance that a principal stockholder of a company, the operating manager, has died and left his stock to his widow who has never taken an active part in the business. In order to provide her with day-today income it would be desirable to put her on the payroll so that she could draw some compensation with which to support her family. Under the reasonableness test of the Internal Revenue Code, however, much or all of such a salary might be disallowed as a deduction to the company with the result that she would have to obtain support through dividends which would be subject to double taxation. An election under Subchapter S would, to some extent, cure this in that all of the income of the company could be readily drawn by her and subjected in her hands to only one tax. It might be feasible in this situation to hire a new manager whose compensation was based in part on profits. In this way, if the manager did well, he would get a share of the profits, but there would be a share left over for the sole shareholder widow—and only one tax would be paid on this income. There would be no corporate tax.

Along this line it should be pointed out that Subchapter S can be an effective estate planning device. In the situation where the stock of a small company is owned, in large part, by one individual who is the manager and the driving force in the enterprise, it would be prudent to arrange the affairs of the company, principally its capitalization, so that it would be available for a Subchapter S election. In this situation, in the event of the untimely death of the owner-manager, his esate or his widow would be in a position to make a Subchapter S election and thereby obtain income funds for the support of the widow and her family. In this connection it should be pointed out that whereas the ownership of a stock by a trust will defeat a Subchapter S election, the ownership by an estate will not.

Subchapter S also offers some help in the multiple corporation problem. In the last few years, the Internal Revenue Service has stepped up its efforts to police this area to deny to additional corporations controlled by the same group of stockholders the benefit of the surtax exemption. One section of the Code denies this exemption in certain cases where the corporation was formed for the purpose of obtaining it.

Subchapter S appears to provide the answer. If in the first years the subchapter is applied, it is plain that there is no attempt to utilize the tax exemption. If the Subchapter S status is terminated after a year or two, the Service would have difficulty in denying the surtax exemption at that time.

Operating a Subschapter S Company

Potentially, the most dangerous pitfall confronting the owner of a company which has made a Subchapter S election involves the problem of thin incorporation. The Commissioner's Regulations issued under Subchapter S suggest that in the event that the company has only a nominal equity account and a large amount of debt which is owed to the stockholder group (a typical thin corporation situation) the Service could hold that the debt was equivalent to a stock interest. The regulations go on to say, however, that in the event that such a holding is made, the debt will be considered to be a different class of stock from the common stock outstanding. In this situation, then, the company would be considered to have two classes of stock dating back to the date the debt was first incurred, and for that reason its Subchapter S election would be nullified. If during the interim the stockholders had distributed large amounts of the income of the company, the corporation would have to pay a tax on all of its income computed under the ordinary rules for corporations. The stockholders would also be taxed, as the distribution to them would constitute ordinary dividends, at least to the extent of the earned surplus existing after the charge for the corporate tax. If a company is intended to be a Subchapter S corporation from the inception, there is generally no need to run the thin corporation risk. Since all the income will be taxed to the stockholders virtually as earned there is no income tax problem in withdrawing money from the company, whether this money is labeled paid-in surplus or earned surplus.

Much of the commentary relative to Subchapter S deals with the problem of planning distributions of income with the intention of minimizing income tax. One device which is effective in this situation, and which is not generally available to a partnership, is the overlapping fiscal year. When a Subchapter S corporation is organized it can adopt a fiscal year other than a calendar year, which ordinarily would be the fiscal year of the stockholders. Under the Subchapter S rules, distributions of income are taxable in the year received by the stockholders. Undistributed income, on the other hand, is taxable to the stockholders in the year in which falls the last day of the corporation's fiscal year. Therefore, by timing distributions properly, the corporation's income may be allocated between the two taxable years of the stockholders to obtain the optimum tax result.

A new corporation may adopt whatever taxable year it desires regardless of whether it intends to elect under Subchapter S. Once having made such an election, a change in fiscal year requires prior approval of the Internal Revenue Service. Under certain conditions, of course, corporations are authorized by the Regulations to change fiscal years without requesting prior approval. In December 1959, however, the Regulations were amended to deny this right

to a corporation having an election under Subchapter S in effect. The Regulations go on to provide that ordinarily approval of a change of taxable year will be denied if the effect of the change is to cause a deferral of taxable income in the hands of a shareholder of a Subchapter S corporation.

Having selected a fiscal year, it is possible through a change of stock ownership toward the end of the year to reallocate the income of the company. The rules provide that undistributed income is taxed to the stockholder owning the stock on the last day of the corporation's fiscal year. Accordingly, a gift from father to son, or a sale from one stockholder to another, toward the end of the fiscal year will have the effect of reallocating the taxable income. It should be emphasized in this case, however, that such transfers must be bona fide and if the company should develop a pattern of transferring stock back and forth between interested stockholders from year to year, the Internal Revenue Service would be justified in ignoring the transfers as not having substance.

Losses on the other hand can generally not be bought, sold or given away. The rules involving losses provide that the loss for the year is allocated day by day according to the stock ownership, and if a share of stock changes hands at the middle of the year the proportionate part of the loss allocated to that share of stock would be claimed one-half by each of the shareholders who owned the stock during the year.

The Effect of Capital Gains

Capital gains retain their special status in the hands of the stockholders, with one modification. An operating loss serves to offset the capital gains and only the net amount is picked up as capital gain by the stockholders. If in one taxable year the company has capital gains in addition to ordinary income, they are applied pro rata to each distribution and to the undistributed income. For example, if capital gains represent 10% of the income for the year, then 10% of each distribution and 10% of the undistributed income will be considered to represent capital gains.

The pass-through of capital gains can cause some tax problems to the stockholders having different taxable years. If, for instance, a Subchapter S company which has a fiscal year ending November 30, realizes in December, the first month of its fiscal year, a large capital gain and makes a substantial cash distribution to the stockholders, this distribution is taxable to the stockholders in their calendar year and they would have to pay the tax on it by April 15. Conceivably, however, this same Subchapter S company will have capital losses during the balance of the year and will in effect reduce the amount of its capital gain income which is subject to capital gain treatment in the hands of the shareholders. Consequently, on April 15, when the shareholder files his tax return and has to identify the portion of the December distribution that was a capital gain distribution, he can not do so with reasonable certainty. Presumably the return would be filed in April showing the stockholder's best estimate of his capital gain and ordinary income situation and would be amended at a later date after the return of the Subchapter S company is eventually filed.

As a practical matter, the stockholder would be well advised to treat his distribution as capital gain in order to put himself, in effect, in a deficiency position. This position can be promptly rectified by filing an amended return and paying the additional tax when the amount of the distribution that might be ordinary income has been determined. The alternative procedure of estimating a higher tax involves the rather difficult situation of possibly having to claim a refund, which is probably the surest way available of inviting an examination of the stockholder's tax return and of the company's tax return, with all the inconvenience and uncertainties that that involves.

It should be noted, of course, that the problem can go the other way. The distribution in December may be at a time when the company has only ordinary income. Subsequently, after the stockholder files his personal tax return the following April, the company may realize a substantial capital gain. In effect the realization of the gain has a retroactive effect on the earlier distribution, rendering a portion of it as capital gain. Almost inevitably, in this situation, the stockholder gets into a position where he has overpaid his tax.

Miscellaneous Provisions

In the administration of Subchapter S there has been a somewhat surprising development. The return form, as designed, contains no reconciliation of the change in surplus with taxable income. Rather, there is substituted a reconciliation of book income with taxable income.

Debts and credits to surplus therefore, representing prior year items, a fairly common accounting procedure although not in line with generally accepted accounting principles, are not shown in the return at all unless voluntarily reflected in taxable income. If, for instance, a company were to receive and credit to surplus an amount of income which appeared to be properly a prior-year item for federal income tax purposes, there would be no disclosure of it on the return.

The rules for the election to be taxed under Subchapter S make it relatively easy to become a Subchapter S company. Furthermore, the rules make it relatively easy to relinquish a Subchapter S status should this become desirable. After that, however, there is a five-year waiting period before the company can again become a Subchapter S company. Furthermore, the election is denied to a successor corporation. A successor corporation is defined in the Regulations as one which is owned at least 50% by stockholders of the prior corporation, and which acquires a substantial portion of its assets.

This, then, is the private world of Subchapter S—a somewhat unique taxation scheme superimposed on top of the general plan of the Internal Revenue Code. Its benefits have probably been oversold, and its pitfalls have probably not all come to light. But it does represent an additional device in the hands of a tax practitioner to help achieve an equitable result.

Two Touring Professors Treat Us to Some Observations on the Austrian Accounting Profession

Public Accounting in a Socialistic-Oriented Society

By Vernon K. Zimmerman
and H. Peter Holzer

Austrian Politics

The Austria of today is a tiny European country of some 7,000,000 people. This country has had an important history as a mighty Central European empire and still enjoys a total influence that belies its current size. In this era of cold war and heated ideological exchanges between the advocates of the communist and free enterprise political systems, Austria offers an interesting society that may perhaps be best described as following a middle road both economically and politically. An Austrian socialist would be the first to deny very vigorously any kinship to the contemporary communist society and an American—although not in a completely strange climate—would find present-day Austrian society considerably left of that in America.

The contrast of certain aspects of Austrian economic life to that in America centers in the ownership of the basic industries, such as steel, oil, and power. In Austria these important parts of the total national economy are owned and controlled by the state. Additionally, other areas of economic activity believed to be of immediate importance to the average Austrian citizen are state controlled. For example, Austria today presents some sort of renter's paradise; under the state housing rent system control the ratio of rent costs comparing 1961 to 1938 is 1:1, while the general price level comparison of the two years is approximately 10:1. Although not completely controlled (as their incredibly large number of small retail shops indicate), the state-controlled Austrian economy offers a rather sharp contrast with the existing American business environment and allows a number of interesting and informative comparisons.

Accountancy, together with its uniquely public professional adjunct, auditing, is generally recognized as being a useful and necessary instrument in both economic analysis and control regardless of the particular trappings of the existing local political system. This is illustrated by the increasing study and acceptance being given to national income accounting by many different nations. Also, even for American non-profit institutions, an accounting system with its various methods of financial control and reporting is an expected and necessary circumstance. The question then arises, is the practice of accounting, or more specifically, public accounting, substantially similar even under differing social systems? An examination and appraisal of the current training and regulation of the practice of public accounting by a society of different economic orientation, such as Austria, should allow a useful answer to the question based upon actual experience.

The Austrian Accounting Profession

Public accounting is recognized as a profession in Austria and is regulated by certain specific laws. Of possible interest to the American Institute of CPAs and the individual state CPA societies in which membership is voluntary is the fact that the Austrian public accounting statute provides for a national professional accounting association in which membership by all practicing public accountants is *compulsory*.

Many of the basic requirements for public practice familiar to American public accountants are also found in Austria. Minimum age and educational standards are legislatively prescribed, but the Austrian accounting laws are somewhat more complicated than their American counterparts because of the threefold classification of accountants that exists in Austria. This three-fold classification is important both socially and professionally. As such, the exact classification is not only very important to the practicing accountant himself, but also to Austrian society in general. Austrians are extremely conscious of titles and positions and seemingly prefer to recognize and perpetuate these status differentiations even in daily conversations.[1]

The three classifications of public accountants that are prescribed and rather vigorously maintained by Austrian law are: [2]

(1) The *Wirtschaftsprüfer*, known generally in German-speaking countries as the "WP." This classification corresponds closely to that of the American CPA or the English CA.

(2) The *Buchprüfer*. Perhaps this classification can be said to contain the public auditors, an authoritative position, but somewhat less prestigious than that of the Wirtschaftsprüfer.

(3) The *Helfer in Buchführung und Steuersachen*, literally and correctly translated as accounting and tax assistant.

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[1] The authors were impressed and flattered by the degree of concern given to this matter of titles and relative social positions during a stay in Austria. An introduction as Herr Professor Doktor is an unforgettable experience. An additional note may be of interest to those concerned with the social implications of the rapid emancipation of women in the American society. In Austria, not only does the Austrian woman enjoy suffrage, but she also can in complete good taste usurp her husband's titles and professional designation as her very own. Thus it is that one can be introduced to a Frau Professor Doktor or a Frau General Direktor.

[2] *Bundesgesetz* (Federal Law) of June 22, 1955 über das Berufsrecht der Wirtschaftstreuhänder, Section 2.

The total number of public accountants in Austria is relatively small. Recent statistics [3] reveal the following totals of Austrian public accountants and accounting firms for each of three classifications:

	Number of Practitioners	Number of Firms
Wirtschaftsprüfer	163	23
Buchprüfer	712	8
Helfer	1244	2
Totals	2119	33

Members of all three of the above categories are active in the practice of public accounting in Austria. Their professional influence is indicated in descending order. The road to each of these levels of professional attainment is clearly outlined in Austrian law and is again indicative of a society that places a heavy emphasis upon rather rigid status designations and identifications. Legal specifications of membership in and practice of certain occupations in Austria is not limited to the so-called professions, such as law, medicine, and accounting, but rather generally applies to all occupations, no matter how menial or unprofessional they may appear at first glance. It is difficult for Americans, for example, to picture and to appreciate a social structure in which members of all occupations, even such as a window washer, must fulfill certain specified periods of apprenticeship and training. One should be careful to appraise the Austrian public accounting profession within the frame of reference of its relative position within a society that received much of its specific structure and orientation from the firmly stratified societies of the medieval and Baroque eras.

Experience Requirements

The experience requirements necessary to practice public accounting in Austria offer an interesting contrast to those required of American practitioners. Here again, one can note the influence of the apprenticeship system—another heritage of Austria's medieval and later history.

The Helfer is not, as the name might imply, free of an experience requirement. He is not just a junior auditor, but rather a fully-accredited and respected member of the entire body of practicing accountants. The Austrian law requires three years of experience under the direct supervision of either a Buchprüfer or Wirtschaftsprüfer for the Helfer candidate. Of this three-year experience period, as much as 1½ years need not be in actual public accounting practice, but may be in any accounting-oriented activity in business or government.

The Buchprüfer must have had three years actual experience as a Helfer or, as an alternative, have had a total of 6 years of experience in the office of a Wirtschaftsprüfer or Buchprüfer. Three of these 6 years may be spent as an accounting teacher in a high school or college. It is interesting to note that a candidate for Buchprüfer need not first have served as a

[3] Report of Kammer der Wirtschaftstreuhänder.

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Helfer. That is, one can, if he wishes, take examinations for a higher classification without first passing lower classification examinations. Most Austrian accountants do seek the various classifications in normal sequence, however.

The experience requirements for the Wirtschaftsprüfer are on a still higher level—three years of experience as a Buchprüfer or at least six years experience in the office of a Wirtschaftsprüfer or Buchprüfer (including some actual experience in the auditing of financial statements). In the case of both the Wirtschaftsprüfer and the Buchprüfer, as much as one-half of the six-year experience requirement may be taken in business or governmental positions provided the employment is directly related to either accounting or auditing.

Minimum Age

The Austrian society is so structured as to cause one to think of the Chinese tradition of ancestor worship. The fact is that in Austria the possibility and probability of achieving individual success, not only in the practice of accounting, are reserved for a much more mature age than is the case in America. "Boy wonder" is an unknown phrase in the usual Austrian business vocabulary.

The minimum age permitted for private pracetice in Austria for the Wirtschaftsprüfer and Buchprüfer is 30 while the Helfer must be at least 24. In addition to his higher average age, the Austrian junior accountant also experiences a much greater salary differential as between juniors and partners than is the case in America. It is interesting to note that this greater disparity in incomes has developed under the more socialistic-dedicated government.

Educational Requirements

Collegiate education in Austria is a privilege extended only to a few. Some estimates place the percentage of the total Austrian population attending colleges and universities at from 2 to 3%. In contrast, in 1956 it was estimated that 35% of all American high school graduates enrolled in college. As might be reasonably expected, the limited enrollment practices employed by Austrian education succeeds in keeping the average academic potential very high in relation to that prevailing in America under its different concept of educational opportunity and obligation.

A secondary school certificate is stipulated for the Helfer, but an academic degree from an Austrian university is required for all Wirtschaftsprüfers and Buchprüfers. Of interest to Americans is the fact that this academic degree can be in any of the following widely diverse fields: business administration, economics, law, political science, or agriculture.

Professional Prerogatives

The Wirtschaftsprüfer, as mentioned before, is the most prestigious classification and is also the sole possessor of certain professional rights. The Wirtschaftsprüfer alone is granted the important right to perform certain specified accounting and auditing functions. These functions concern publicly-owned corporations —an Austrian equivalent of those American companies whose stocks are publicly traded. The only exceptions (and again a similarity to American practice, such as FCC and CAB ac-

counting regulations, is seen) are certain Austrian corporations engaged in publication transportation where the audits must be performed by designated governmental agencies. In addition to this private domain, the Austrian Wirtschaftsprüfer may render any services permitted to be performed by either Buchprüfers or Helfers.

The Buchprüfer is permitted to audit and certify financial records of all businesses except those specifically noted above. Approximately 400 Austrian corporations [4] are estimated to be excluded from the Buchprüfer client potential by this limitation. The excluded corporations are nearly all large concerns whose capital was derived from widespread stock subscriptions. There are many other Austrian corporations for which the Buchprüfer may audit and certify their financial records.

In addition to the allowable area of audit practice noted, the Buchprüfer may give expert opinions before courts and other bodies on questions of accounting, taxation, and other matters which presuppose an expert knowledge in the fields of business administration, accounting, and commercial law. The Austrian courts also recognize that persons other than Buchprüfers may be qualified to give expert opinion in this area. Permission to serve as a consultant in foreign exchange matters and all services legislatively permitted to the Helfer complete the range of possible accounting-type services legally possible for the Buchprüfer.

The more numerous Helfers are permitted to perform the following professional services:

(1) audits which do not require certification
(2) consultations in the area of accounting
(3) consultations in the area of taxation and also representation of the client before the federal tax authorities
(4) advising in matters of cost accounting and organization
(5) time and motion, wage rate, and other related studies
(6) administration of properties as a trustee
(7) legal consulting if closely related to the above activities

Even those vocal advocates of an extensive enlargement of the management services field of contemporary American public accounting would probably find some of the services noted above as well beyond the scope currently ascribed to American public accountants.

Professional Examinations

The examination given to candidates for any of three possible professional classifications reflect some of the differences in academic concepts and practices existing between Austria and the United States. In addition to the successful completion of a comprehensive two-day written examination, the Austrian auditing candidate must also submit a satisfactory thesis on an assigned subject from the general area of business administration. A final psychological and technical hurdle for all candidates in Austria is a rigorous oral examination by the members of his committee.

The Kammer der Wirtschaftstreu

[4] Some of the largest of these are nationalized, but even these state-owned corporations must be audited by Wirtschaftsprüfers.

händer,[5] an Austrian counterpart of the American Institute of Certified Public Accountants, administers all professional accounting examinations. The total number of candidates in Austria is small enough to allow a single examination committee of a chairman and three additional members to administer personally all examinations given in the entire country. These influential examination committee members, usually practicing public accountants, professors, or high-ranking governmental officials, are appointed by the national accounting organization after consultation with the national Ministries of Finance and Economics. This would be somewhat comparable to approval of American Institute officer selections by the Department of the Treasury or the Securities and Exchange Commission.

The size of the examining committee and the scope of the examination again reflect the social and professional distinctions made among the three classes of Austrian professional accountants. Whereas the Wirtschaftsprüfer and the Buchprüfer have a four-member examining committee, the less advanced Helfer rates only two examiners. The Helfer has a written examination in the specific area of taxation, but the oral questioning covers all areas of taxation, business law, and the laws applying to the accounting profession. For the Wirtschaftsprüfer and the Buchprüfer the written examination is expanded to include all areas of business administration and complements the broadening of the area for oral questioning for these candidates to include such topics as the theory of the business enterprise, accounting theory, accounting law, cost accounting, statistics, auditing, finance, taxation, economic theory and policy, business law, and civil law.

An unsucessful candidate may at the discretion of the examining committee make two additional attempts, but no more. The successful candidate is publicly appointed as a public accountant and is formally sworn in.

Accounting Corporations

Corporate, as well as partnership, organizations are permitted for Austrian public accounting firms. Certain interesting legal requirements do exist. Partners or shareholders of Austrian public accounting firms as the organizational structure dictates, must be properly licensed accountants of the classification (Wirtschaftsprüfer, Buchprüfer, or Helfer) as the firm title indicates or *their spouses*. This eligibility of the spouse is interesting and affords a degree of financial protection to the widow but also follows the Austrian social practice of attaching all degrees and titles earned by the husband to the wife.

A Wirtschaftsprüfer must have a majority of its partners who are of this professional classification. The other members may be Buchprüfers or Helfers. A similar majority percent-

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[5] The nature of the Kammer der Wirtschaftstreuhänder, and its comparability to the AICPA can be appraised to some degree by noting the declared purposes of the Kammer:
(1) to represent the interests of all public accountants
(2) to consider the needs and suggestions of other groups pertaining to public accounting.
(3) to represent the interests of public accountants before legislative bodies and other governmental agencies
(4) to promote continuing professional development
(5) to support the training of young prospective members of the profession
(6) to exercise disciplinary authority over members in accordance with legal requirements
(7) to administer professional examinations.
(Federal law of December 10, 1947, BGB1 No. 20/1948, section 2)

age rule is applied to the shareholders of an Austrian Wirtschaftsprüfer corporation.

Vestiges of medieval guild practices and the apprenticeship system so generally observed in Europe are present in the Austrian law that stipulates that not more than five assistants (junior auditors) may work under the supervision of a single Wirtschaftsprüfer.

Influence by Society

An overall evaluation of the Austrian public accounting profession would be incorrect if the unique social setting in which it serves were not considered. As indicated, many features of contemporary Austrian accounting practice reflect practices and social concepts of long acceptance and unusual durability. The examination procedures, the strict classification of professional attainment, and apprenticeship practices are illustrative of the position the practice of public accounting holds in Austria today. The differences from American practice are interesting of themselves, but more importantly, are significant by their indication that the social usefulness of the accounting profession exists and is recognized even in socialistic-oriented society.

The Management Letter—An Annual Report Supplement

The CPA, in general, is more likely to err in being too conservative in venturing his criticism and offering assistance in business areas outside the accounting function. Most experienced CPAs are well qualified in varied business fields. Many accounting firms now have men who specialize in management services. To send these men to the client on a technical "scouting" basis would result in more intense management surveys. This could provide excellent material for management letters thereby creating good will with the client. Bringing these specialists into contact with the auditors and giving them the opportunity to read a management analysis of a situation with which they are familiar would assist in training staff members. Many times the management reports would result in additional revenues to the accounting firm through developing broader scope examinations and special service engagements.

WILLIARD E. STONE, CPA
New York CPA
September 1961

TAX COMMENTS: Prepared by the Committee on Taxation of the Illinois Society of Certified Public Accountants

Taxes and International Business

METHODS OF CONDUCTING NTERNATIONAL OPERATIONS

In organizing a foreign operation, e legal form given to the venture n be most important from both the isiness and the tax standpoint. The nplest method of all, and the one ost commonly selected by smaller ganizations, is to obtain a foreign les agent, distributor or licensee. xt in line is the establishment of a anch by the United States company the site of the foreign market. osely related to this is the formation a domestic subsidiary of the U. S. mpany. None of the above, except certain limited areas which will be ted, has any particular tax advan- ge to the U. S. company. Finally, form most often selected for large- ale operations, and the primary bject of this article, is the entity eated under foreign law (common civil) as a corporate subsidiary of U. S. corporation.

reign Sales Agent, Distributor Licensee

As noted, entering into an agree- nt with a foreign representative market U. S. products in his par- ular locality is the simplest form of doing business outside the U. S. Closely allied to this procedure is the use of a licensing agreement which gives the foreign representative the right to make the product as well as market it. Some very large companies still handle much of their foreign business by the use of one or both of these methods. The major advantage is in the savings of funds, attention and personnel invested abroad. It should be emphasized that this is a form of partnership locally. Naturally, much depends on the individuals or organizations through which a compay acts. If a good selection has been made, the results will probably be good, and vice-versa. This proposition is no different from in the U. S. Of course, there is no tax saving or deferral, since all the income generated from these arrangements is subject to U. S. corporate taxes.

Branch Operation

In this country, a branch is usually considered efficient and practical from the standpoint of everyday operations. The problem abroad, however, may be more complicated.

Possibly the greatest incentive to the use of a branch abroad lies in the

possibility of incurring losses in the foreign operations. Many countries have only limited provisions for the carry-over of operating losses. If losses are incurred initially in a separate corporation organized in such a country, it may not be possible to generate profits fast enough, if at all, to offset those losses. Losses of foreign subsidiaries cannot be utilized against the current income of a U. S. parent corporation. If losses are anticipated, the branch form may provide the greatest tax benefit because branch losses are currently deductible against U. S. taxable income.

In spite of this advantage, there are a number of reasons why the branch form of doing business may not be feasible. One of the most intangible reasons stems from the nationalistic feeling of the people in some countries, particularly in Central and South America, who wish to do business only with a corporation organized in the particular country involved. Also, foreign tax law may so discriminate against foreign branches that the separate foreign corporation is the only feasible business form.

Domestic Subsidiary Corporation

As stated, the corporate form is most generally selected for the large-scale enterprise. Since a domestic corporation is liable for income taxes in the U. S., no tax advantage is available in general from such a setup. However, there are two special circumstances where a domestic subsidiary may prove effective taxwise.

Western Hemisphere Trade Corporation. The best known of these is the Western Hemisphere Trade Corporation (WHTC). If such a corporation meets all of the prerequisites of the Internal Revenue Code, it is entitled to a special deduction from taxable income equal to 14/52 or 26.92 per cent of taxable income. This is equivalent to taxing the income at a rate ranging from 27 per cent on taxable net income of $50,000 to 37½ per cent on income of $1,000,000.

The rules which must be met before being qualified as a WHTC are:

a. 90 per cent of the company's gross income must be derived from the active conduct of a trade or business,

b. 95 per cent of the corporate income must be drived from sources outside the U. S., and

c. all of the corporate activities must be within the Western Hemisphere.

For the past several years, th U. S. tax status of WHTC's has bee quite uncertain. The WHTC pro visions were enacted into U. S. ta law at the suggestion of the U. S State Department as a means of in creasing trade within the Wester Hemisphere. As is quite often th case in the U. S., the taxing authori ties are not too interested in th social, economic or political motiva tion which gave rise to WHTC pro visions. As protectors of the Treasury they feel that it is their duty t interpret the statutes as strictly a possible and to try their utmost t limit the use of the legislation.

As a result of the Treasury De partment's zealousness, and partl because of some business reluctanc to segregate properly its WHTC ac tivities from its parent activities, number of WHTC's have been at tacked by the U. S. Internal Revenu Service. A number of cases ar pending at the various stages o Treasury Department review or cour action while others have been settle informally.

Of the cases which have been handed down by the lower courts (*Barber-Greene Americas, Inc.* and *A. P. Green Export Co. vs. U. S.*), the Commissioner of Internal Revenue has suffered a tremendous setback. The courts have all held that under the facts of the cases, the Commissioner's two basic grounds for attack were not correct. In the first place, the company was not guilty of tax avoidance by arranging its business activities to come within the WHTC sections of the Code. In the second place the Revenue Service could not show that the companies involved had arranged passage of title to their products, which determines source of income and U. S. taxation, strictly for tax avoidance purposes. The *Barber-Greene* case was appealed, the appeal was denied and the Commissioner has recently acquiesced. The *Green Export* case was not appealed.

The logical question then is: What is the status of WHTC's for U. S. tax purposes? If a WHTC has a bona fide business operation outside the U. S. and has a good business reason for the manner in which it relinquishes ownership to goods outside the States, the company should have no trouble with the Internal Revenue Service. On the other hand, if the WHTC has only a thin veil separating it from its parent export operations, no major activities outside the U. S. and only a tax reason for arranging title passage outside the U. S., then the WHTC should expect trouble. The Service has definitely not given up its scrutiny of WHTC's. It is even trying alternative approaches in an attempt to reach the same result. The latest approach is to try to allocate the entire net income of the WHTC to the parent company under Code Section 482 which gives the Commissioner the permission to allocate income and deductions between organizations where such is necessary to prevent evasion of taxes.

Possession Corporations. The second area where special treatment is accorded domestic corporations under the U. S. tax law concerns income derived from possessions of the U. S. The Internal Revenue Code completely exempts from tax income earned in a possession of the U. S. if at least 80 per cent of the gross income was derived from sources within a possession of the U. S. and 50 per cent or more of the gross income was derived from the conducting of a trade or business within a possession. The Virgin Islands are excluded from this consideration. Puerto Rico, however, is included. The combination of this U. S. provision with Puerto Rico's tax incentive program has allowed some U. S. corporations, through domestic "possessions" companies, to earn income free from U. S. and Puerto Rican tax for further use in Puerto Rico or other countries. The earnings of such domestic "possessions" companies may be returned free of tax to the parent by way of a tax-free liquidation under Code Section 332.

For a continuing "possession" company, two points should be noted: (1) no foreign tax credit is available to the subsidiary since the income is not subject to U. S. tax; and (2) dividends paid to its U. S. parent are treated as received from a foreign corporation, i.e., the 85 per cent divi-

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GORDON J. NICHOLSON, partner in the firm of Arthur Andersen & Co., Chicago, prepared the comments for this issue.

dends received deduction is not allowed, even though the parent should be entitled to the "deemed" foreign tax credit.

Foreign Subsidiary Corporations

Manufacturing or Trading. Having dealt with domestic subsidiaries, the next area for consideration revolves around subsidiaries incorporated abroad. Such foreign corporations not doing business in or deriving income from the U. S. are not subject to U. S. income taxes. Of course, the domestic parent corporation will pay U. S. income taxes (with allowance for certain foreign taxes paid by the subsidiary) when the subsidiary's earnings are paid out in dividends. Thus, the major tax advantage of operating through a foreign subsidiary is the deferral of U. S. taxes on foreign profits. The lower the foreign tax rate, the more important the deferral aspect becomes. In addition, to the extent that the accumulated earnings are reinvested and not returned immediately to the U. S., the deferral becomes more pronounced. This is one of the areas presently bothering the Kennedy administration.

A foreign subsidiary may be organized to conduct one or several types of business operations. The least troublesome from a U. S. standpoint is one which engages in manufacturing abroad because there can be little question but that the corporation is established for valid business purposes and not for tax advantage alone.

Trading corporations encounter fewer operating and organizational problems because such corporations are inherently less complex. They are, however, subject to more scrutiny by the Internal Revenue Service. From the U. S. tax standpoint there are two major areas for concern: (1) source of income and the corollary "substance" problems; and (2) the amount of profit realized by the parent on sales to the foreign subsidiary. While the *Greene* and *Green* cases seem to have helped considerably with the question of title passage and "substance" for WHTC's, at least for the time being, there is still a question of the application of these two cases to foreign trading companies as opposed to WHTC's.

The second point, concerning the amount of intercompany profit on sales by a U. S. parent to its foreign subsidiary, is more troublesome. Certainly, just as in the WHTC situation, a parent corporation should not sell to its foreign subsidiary at a loss, unless it can prove that it also would have realized such loss on a sale to an unrelated customer. Although some believe that a parent should be able to sell at its cost, the Internal Revenue Service ordinarily will not so agree. The Service's view is that the parent should realize the same profit as if the sales were made to an outsider. Many tax practitioners believe that the price can be something less than if the sale were wholly at arm's length. Some companies are using cost plus 10–30 per cent in billing their foreign subsidiaries. This range would seem to be a reasonable profit margin in most cases so long as the cost figure used represents all elements of cost, and the product does not carry an extremely high profit margin.

An alternative method of handling trading operations is to set up the foreign subsidiary as a sales agency operating on a commission basis. This

arrangement is used primarily to reduce the complexity of a trading operation. There need be no revamping of title documents, credit and billing can be handled by the parent, etc. The parent merely pays the subsidiary its commission for securing the sale, servicing the customer, etc. While this arrangement does have the advantage of simplicity, it is probably more vulnerable to attack by the Revenue Service unless it conducts substantial selling activities outside the U. S. In addition, it would seem difficult to establish foreign commission income in an amount equal to that which could be earned in an integrated trading operation.

Holding Company. An extension of the use of the foreign corporation has to do with its utilization as a holding company, either as a separate function or as a combination with trading, licensing or technical services. The latter functions have been discussed to some extent already and will be expanded in the following paragraphs.

In order to function with maximum advantage, the foreign holding company should be incorporated in a country which assesses little or no tax on dividend income from sources outside that country. In addition, the country should impose little or no tax on accumulation of earnings and have no significant currency restrictions. Countries used quite often are Panama, the Bahamas, Switzerland, Netherlands Antilles, and until lately, Venezuela. More recently Canada, Holland, Belgium and Luxembourg have come into play.

The major advantage of this method of operation is the possibility of withdrawing profits from a corporation operating in one country and accumulating them in the base company free from expropriation and exchange controls in the operating country and free from taxation. The profits so accumulated can be used to finance operations in other countries either through subsidiaries of the tax-haven corporation or to some extent by loans to affiliated companies. In this way additional capital funds are made available without requiring as large an investment by the parent company. Limitations placed on this method of operation by the proposed "tax haven" legislation will be discussed later under current developments.

Another advantage often cited in the past for this type of corporate arrangement is the ease in averaging foreign tax rates of foreign countries so that the maximum advantage of the foreign tax credit may be taken by the U. S. parent. By statute, a base company is considered to have paid the foreign income taxes actually paid by the operating subsidiaries which meet certain stock ownership requirements. By paying dividends from high tax countries and low tax countries into one pool, the rates in relation to total income are averaged. When income from countries with tax rates in excess of 52 per cent is averaged with income from countries with substantially lower rates, the average tax rate can be reduced below 52 per cent so that, when the income is paid to the U. S. parent, the entire amount of foreign income taxes may be utilized in computing the appropriate credit against U. S. taxes. The new over-all limitation on foreign tax credits provided by Public Law 86-780 as an amendment to Section 904 will eliminate the necessity of mixing foreign income to some extent, but the new provisions have some disadvantages.

U. S. companies which are family-

owned or which have a limited number of shareholders have an additional concern in the use of foreign holding companies. Where the income of a foreign holding company is primarily from dividends, interest, etc., and the stock ownership of the U. S. parent is extremely limited, such income is taxable directly to the U. S. shareholder as it is received by the foreign holding company. If this occurs, then the benefits of deferral of U. S. tax are lost.

CURRENT DEVELOPMENTS

Trends

There is a definite trend in U. S. legislation toward tightening up and policing taxation relating to international trade and investments. This trend is caused by a number of factors:

1. Increase in importance of international trade
2. U. S. balance of payments problem
3. Increase in U. S. unemployment
4. Abuse in the area of taxation by some U. S. businesses.

As a part of the step-up in policing the field of taxation, Congress passed a new provision which requires U. S. companies with controlled foreign subsidiaries to submit certain financial information with respect to its controlled subsidiaries. The information required includes a balance sheet, statement of profit and loss, an analysis of surplus, as well as other miscellaneous information. The information is designed to bring out for intensive review the problem areas of:

1. Allocation of income between companies
2. Substance of foreign companies
3. Thin capitalization (loan repayment)
4. Foreign tax credits.

The new reporting is effective for years beginning after December 31, 1960.

Proposed Legislation

Presently pending before the House Ways and Means Committee is a "discussion" draft of a bill which would amend several sections of the present law and add new sections affecting the taxation of foreign income and operations. This draft is substantially milder than the origina proposal submitted to Congress in April, 1961, but the business community should not be lulled into an overconfident position, since the original proposals may be submitted again in January, 1962, when Congress reconvenes. Outlined below ar certain of the more significant 196 proposals affecting international business.

Grossing Up. This proposal affect the computation of the foreign ta credit by requiring a domestic corporation to add to actual dividend received from foreign subsidiaries th amount of foreign tax applicable t the dividend. In other words, to th cash dividend paid would be adde not only any dividend tax withhel but also the deemed tax otherwise t be claimed as a credit. Thus, highe income would result and a highe U. S. tax would be computed agains which to apply the foreign tax credi The proposal would result in the tax ation of all corporate foreign sourc income in excess of $25,000 at a mini mum rate of 52%. It is an attemp to take away the advantage in th deemed foreign tax credit computa

tion presently available to a foreign subsidiary operation.

Tax Havens. The April, 1961, proposal called for annual taxation on undistributed earnings of certain controlled foreign corporations. Presently, the U. S. corporate taxpayer pays U. S. tax only when such foreign profits are received as dividends. The April proposal would not apply to controlled foreign corporations which were organized in underdeveloped countries unless the company was classified as a "tax haven" company. A tax-haven company was to be defined as one which realizes 80% or more of its gross income from sources outside the country of organization.

The President, in his April, 1961, tax message, cited the strains on the U. S. balance of payments position as one of the reasons for re-examining our tax treatment of foreign income. He felt the fact that a company would have to pay U. S. tax on earnings remitted was keeping much of the foreign earnings from being returned home. He felt further that use of income not taxed in the U. S. for further foreign expansion was, in essence, giving preferential treatment to foreign investment over domestic investment thus adding to the high unemployment figures. To avoid this so-called "artificial encouragement" to foreign investment the administration proposed to tax the U. S. parent on earnings it had never received. Excluded, as indicated, from this taxation were the developing countries, which includes most of Latin America.

After much testimony before the House Ways and Means Committee regarding the President's tax proposals with respect to taxation of foreign income, the Committee decided that insufficient study and consideration had been given to the proposals. Thus, no major recommendations were made in the past sessions of Congress. The Committee's draft of the Revenue Bill of 1961 issued this summer contained no basic recommendations on changes in the taxation of foreign income other than the "gross up" provisions referred to above. The Treasury Department on its own had submitted a discussion draft of possible "tax haven" legislation to the Committee. The Treasury draft proposes to tax to the U. S. parent income from "tax haven" transactions consummated by controlled foreign subsidiaries. Tax-haven transactions would include:

1. Profit (or commissions) on sales of personal property sold outside the country of organization,
2. Income from rentals, licensing or personal services earned outside the country of organization, and
3. Dividends, interest and income from insurance or re-insurance from related persons.

Testimony of businessmen before the House Ways and Means Committee early this year did much to stem the Treasury's drive on taxation of foreign income. The matter will undoubtedly get another review early in 1962.

It is respectfully submitted that the U. S. tax laws with respect to foreign income are not causing the U. S. deficit in balance of payments. This was adequately proved in testimony given before the Ways and Means Committee. Furthermore, to the extent that there is abuse in the area of taxation of foreign income, it is also submitted that the Treasury Department has adequate tools within the

(Continued on page 59)

A Look at Some Implications of the Present Illinois Sales Tax Law

Recent Developments in Illinois Sales Tax Law

By John S. Gaughan

The recent changes in the Revenue Laws of our State have been brought about by court decisions and legislative enactments. These legislative enactments have broadened our Retailers' Occupation Tax and Use Tax Laws, and have given the State two entirely new Laws, The Service Occupation Tax and the Hotel Operators' Occupation Tax.

Lyons Case

The decision in the Lyons Lumber case is the basis for taxing building material sold to contractors. Due to court interpretation, the Department had been precluded from taxing the sale of building materials to construction contractors. A construction contractor was defined as any one who converted tangible personal property to real property on land owned by another. During this period the Department contended that building material sold to speculative builders or real estate developers was taxable.

A speculative builder or real estate developer was defined as one who converted tangible personal property to real property upon land that he owned.

The issue before the court in the Lyons Lumber case was whether a speculative builder was liable for the tax on the purchase of building materials. The court affirmed the Department's position regarding speculative builders and real estate developers and further stated that there was no distinction between a speculative builder, real estate developer and a construction contractor. Prior to this decision, the distinction was that when a construction contractor purchased building materials, he purchased them for resale and, therefore, was not taxable on his purchase; however, when he would sell this property he sold it in the form of real property, thereby escaping taxation on the entire transaction.

The decision was rendered June 14, 1961, and the court did not state that the law was effective from this date or any other date, merely that this always had been the law by specifically over-ruling the Material Service case. However, in fairness to the construction industry, the Department tried to prevent the retroactive effect of the law. July 16, 1961 was selected as the effective date of the tax in order to relieve the retroactive effect on the construction industry.

All building material purchased subsequent to July 16, 1961 will be taxable unless it is purchased to fulfill obligations under binding contracts entered into prior to July 16, 1961. The binding contract provision includes irrevocable bids entered into prior to July 16, 1961, but accepted subsequent to July 16, 1961.

Filing of Contracts

When the Department originally issued its decision as to the effective date, there were no other requirements as to methods of proof other than the contractor making a statement to the supplier that these items were purchased in connection with exempt contracts. In the Department's Rule No. 15, issued August 9, 1961, the Department has clarified its position as to the requirements for the exemption. If a contractor wishes to avail himself of the exemption under the binding contract rule, he must file a copy of the contract with the Department, and further, at the time of purchasing the material he must give an affidavit to the effect that he has filed the contract with the Department of Revenue and state the name of the party with whom he contracted, location of the contract and the date the contract is issued.

Prime Contract

In explaining what contract was to be filed with the Department of Revenue, the words "prime contract" or "basic contract" were used. These words were used in a general sense. The contract which is to be filed with the Department varies in each individual case. It is the contract upon which the contractor relies for the exemption; e.g., in connection with the construction of homes, it is the contract with the ultimate owner of the home. Unless the ultimate owner had entered into the transaction prior to July 16, 1961, then all material purchased to build that home will be subject to tax.

With regard to commercial construction, the prime contract could be both the sub-contractor's contract with the general and the general contractor with the ultimate owner; e.g., if the general contractor had entered his contract with the owner of the property prior to July 16, 1961, but had not signed up his sub-contractors, his exemption under these circumstances could be passed on to the sub-contractors and the contract which should be filed in this instance would be the general contractor's contract with the ultimate owner.

If both a general contractor's contract with the ultimate owner and the sub-contractor's contract with the general contractor were entered into prior to July 16, 1961, the subcontractor can rely upon his own contract for exemption and that contract should be filed with the Department of Revenue.

The entire contract with the exception of the engineering and architect's specifications and drawings must be filed with the Department of Revenue.

Method of Obtaining Tax

The contractor is not considered a retailer under the Retailers' Occupation Tax, but will pay the tax when he purchases the materials and does not have to file any reports with the Department of Revenue.

Dual Capacity—Retailer and Contractor

If the contractor has a dual capacity where he sells building materials

from a retail outlet and also uses these materials to fulfill his contractual obligations, and at the time of purchasing these materials, he does not know what their actual disposition will be, he can give a resale certificate to his supplier and account to the State for any tax due on these materials.

Olin-Mathieson Case

At the present time the Department cannot tax any transactions with the federal government or with the contractors dealing directly with the federal government. The Department is restrained from taking any action to enforce its Revenue laws because of an outstanding injunction in the Olin-Mathieson case. On October 6, 1960 the Olin-Mathieson Company sued the Department of Revenue in federal court requesting a three judge court stating that the State of Illinois tax on sales to the federal government was unconstitutional. The federal government joined in this case stating they were a party in interest.

The two points raised by the plaintiffs were that the tax on sales to the federal government was unconstitutional per se, and that if it was not unconstitutional per se, the method that the State of Illinois was using was unconstitutional because it discriminated against the federal government when the State did not tax sales to the State of Illinois and its political sub-divisions. This discrimination was brought about by the exemption in the law for the State of Illinois and its political sub-divisions, but no exemption in the law regarding the federal government. The three judge court found in favor of the Olin-Mathieson Company and the federal government stating that it was not unconstitutional per se to tax the federal government, but the method used by the State of Illinois was unconstitutional because it was discriminatory. This case is now on appeal to the United States Supreme Court and until final action is taken on the injunction, the Department cannot, in any way, enforce its tax laws on sales, either direct or indirect, to the federal government.

Holland Coal Company

This case is directly tied in with the Olin-Mathieson case. Subsequent to the decision in the Olin-Mathieson case stating that the clause exempting the State of Illinois and its political sub-divisions was unconstitutional, a taxpayer brought a suit against the Director involving this very clause, stating that if this clause was unconstitutional because it discriminated against the federal government, it was also unconstitutional regarding any exemptions mentioned in the clause. The State Supreme Court in March, 1961 rendered a decision agreeing with the taxpayer, holding that the entire clause exempting the State and its political sub-divisions and religious, charitable and educational institutions was unconstitutional. This had two effects. It allowed the State then to amend its brief before the United States Supreme Court, asking it to take into consideration the Holland Coal Company case that in effect declared the discriminatory clause unconstitu-

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tional, giving this clause no legal effect from its initiation, thereby having the effect that no discrimination existed in law against the federal government, and it was proper to tax the federal government because the State actually should have been taxing the State and its political subdivisions and the charitable, educational and religious institutions. As a result of this case, the State is in the position of taxing themselves but not taxing the federal government until the injunction in the Olin-Mathieson case is finally resolved.

On September 22, 1961, the Illinois Supreme Court modified its decision in the Holland Coal Company case and restored the exemptions to charitable, educational and religious institutions. This really did not have any effect on the Department of Revenue, because in the interim, a law had been passed granting the same exemption to these institutions.

Exempt Organizations

Under the present law the exemption applies only to organizations that are exclusively charitable, religious or educational. This exemption applies to all purchases by these organizations.

The exemption from tax on sales has been limited by rule. The nature of the item that is sold by the exempt organization will determine its taxability. If the exempt organization sells a product that is of a competitive nature, the sale is subject to Retailers' Occupation Tax, whether it is sold to the public or to members of the organization.

There is one exception in connection with the dispensing of food by an exempt organization. If the exempt organization runs a cafeteria for its employees or students and it is not open to the public, the sales made by this cafeteria will be exempt from the Retailers' Occupational Tax. The rationale behind this exemption is that if the school or hospital is allowed to dispense food on their own premises, they can then better regulate their hours and fulfill the purpose of the exempt organization.

If an organization is a government operated organization and also has exempt status, then this exempt status will control and the organization will be able to purchase the items tax free. All public supported schools and public supported hospitals will be considered exempt organizations.

Direct and Indirect Purchases

This exemption applies to all purchases, whether the tax would be charged directly to the exempt institution or indirectly, because the supplier would be charged the tax on that item; e.g., under the Retailers' Occupation Tax, the liability for the purchase of construction material falls upon the contractor; however, the contractor is able to purchase these items tax free because of the charitable, educational and religious institution exemption. This exemption also applies to the new Service Occupation Tax, and a serviceman will not have to pay tax on any property transferred to an exempt institution as an incident to his rendering a service.

Broadening of the Retailers' Occupation and Use Tax Laws

The Legislature has expanded the area of taxation under our Retailers' and Use Tax Laws. We shall try to go into the individual topics that are now affected by this law.

Repairs, remodeling and reconditioning. Since July 11, 1957 the repairing of tangible personal property has been considered an item subject to Retailers' Occupation Tax. There were many factual difficulties in connection with taxing these repairs, because of the difficulty of distinguishing between the repairs, remodeling and reconditioning of tangible personal property. Effective August 1, 1961, there is no longer a distinction between remodeling, reconditioning and repairing. They will all be taxable as repairs.

If there is a lump sum charged for this repairing, then the entire charge is subject to Retailers' Occupation Tax. However, if there is an agreement between the repair man and the consumer that there is to be a separate charge for parts and a separate charge for labor, then only the parts will be taxable.

In order to have evidence of this breakdown beween labor and material, the invoice must be separately broken down as to labor and material, or if no invoice is used, then a sign must be displayed in the place of business indicating that the transaction covers both labor and material. If an invoice is used, then the invoice breaking down the charge of labor-material must be signed by the consumer. The signing of this invoice is dispensed with if the repair man uses a sign that informs the consumer that there are two separate charges included in the repair contract.

Custom made and special order types. Effective August 1, 1961, the retail sales of custom made or special order items will be subject to tax if these items serve substantially the same function as a standard item. This law will subject transactions involving custom made clothing, drapes, carpeting and eye glasses made o special order, to the Retailers' Occu pation Tax Laws. There still wil exist the exemption for special orde and custom made items in our law However, these exemptions from th Retailers' Occupation Tax Law hav been greatly reduced by the broaden ing bills.

Magazines, books, phonograph rec ords. Effective August 1, magazines o all kinds, books, phonograph record and sheet music will be subject t Retailers' Occupation Tax. There wil continue to be an exemption on th sale of newspapers. The Departmen had originally taken the position tha magazines, if they were primaril news magazines, would be exemp from our tax. However, after a stud of the law and a re-evaluation of th legislative intent, the Department ha decided to tax all magazines, what ever their nature.

Leasing

Effective September 1, 1961, th renting or leasing of tangible persona property to others is deemed to b selling rather than using. This ta applies to payments received afte September 1, 1961, regardless of th fact that the lease may have been en tered into prior to September 1, 1961

Lessor as retailer. The lessor will b considered a retailer and each leasin transaction will be considered a sepa rate sale. The lessor must registe with the Department and is require to report monthly on the proceed from the leasing or rental transac tions.

Relief provisions. The leasing bi has several relief provisions as to th burden of tax. One of these prov sions allows a credit for all tax previously paid when the propert was purchased. This relief provisio

is on the individual piece of property basis; e.g., if an article costing $1,000 was purchased prior to September 1, 1961 and leased subsequent to September 1, 1961, the first $1,000 of lease payments can be recovered tax free.

7 **Total rental payments taxable.** The total rental payments are taxable, even though they may include insurance and maintenance expenses of the lessor. However, there is a provision that states if insurance and maintenance charges are specifically contracted for and separately billed, then the tax will apply only to the rental payment and not to the insurance and maintenance charges.

Long term and short term leases. Long term leases and short term leases are treated basically the same, with one exception. On a given single long term lease concerning a specific piece of property, the rental payments that exceed what would have been the normal purchase price, had the lessee purchaser decided to buy that property rather than rent, will be treated as tax free payments.

Sales of items previously leased. The sale of property that has been previously leased will be subject to Retailers' Occupation Tax if this item is sold at retail. There is a further relief provision in connection with this sale—that if the property is sold to the lessee and the sales agreement gives credit for rental payments previously made, then the Department will give the same credit and only tax the net cash involved in the transaction.

Service Occupation Tax

The Service Occupation Tax is an entirely new Tax that was enacted by the Legislature. The effective date is August 1, 1961, and it is a tax upon the service man when he transfers tangible property as an incident to rendering the service. A service man is one who is in the business or profession of rendering a service to his customer or client and as an incident to that service, he transfers tangible personal property. The service man is liable for the tax on the material that he transfers as an incident to his service. When the service man purchases these supplies, he pays the tax to the supplier who acts as a collecting agent for the State and remits the tax to the State monthly.

Examples of Application of Service Occupation Tax

Examples of transactions that are taxable August 1, 1961, because of the new service taxes are:

(a) Purchasers of paper and ink by printers for incorporation into special printed matter produced for users and delivered in Illinois.

(b) Purchases of metal and other ingredients by special tool, die, pattern and machinery producers who incorporate such items into products which are special enough to continue to be exempt under the Retailers' Occupation Tax Act, and which are produced for users and delivered in Illinois.

(c) Purchases of bandages, medicine and other tangible personal property by doctors for retransfer to patients as an incident to furnishing professional services.

(d) Purchases of drugs and medicine by druggists for use in filling prescriptions.

(e) Purchases of tangible property

for retransfer as an incident to service, such as:

(1) Fillings, medicine, etc., by dentists;
(2) Eyeglasses, etc., by optometrists;
(3) Stock tonics, medicine, etc., by veterinarians;
(4) Arch supports, trusses, braces, etc., by chiropodists, osteopaths and chiropractors;
(5) Hair tonics, lotions, etc., by barbers and beauticians;
(6) Collar supports, coat hangers, etc., by laundries and dry cleaners;
(7) Sensitized paper by photographers, book bindings by book binders and other items by graphic arts servicemen.

(f) Purchases of tangible personal property for retransfer, as an incident to service, by persons who service tangible personal property for users (Painting, waxing, simonizing, car undercoating, shoe shining, etc.) where such servicing does not make the serviceman liable for retailers' occupation tax as a repairman, and purchases of tangible personal property by other servicemen for retransfer as an incident to service.

Dual Capacity

There will be many instances where a man could have a dual capacity as a serviceman and a retailer. In these instances the same property could be sold directly to the user and also transferred as an incident to a service. Under these circumstances the property can be purchased tax free and the party having the dual capacity will account to the State for any tax due on the disposition of this property.

For example, a printer could purchase paper and ink for special order printing work as well as printing orders that would be subject to tax, and a drug store could purchase drugs that could be sold by prescription and subject to Service Occupation Tax and also sold by brand name and subject to Retailers' Occupation Tax.

Special Problems

Opticians. Under the present law an optician is not considered a service man because he is not engaged in a professional occupation. When an optician transfers the sale of glasses to the ultimate user in connection with a prescription, this is considered a sale subject to Retailers' Occupation Tax. If the optician transfers the glasses to an oculist or optometrist who in turn transfers the possession of these glasses to the patient, the optician is then considered a supplier of the service man and collects the Service Occupation Tax and remits it to the State. When the optician acts in the capacity of a supplier of the service man, the tax base is the entire invoice price to the optometrist or oculist.

Multiple service man situations. There are areas in the law where we have multiple servicemen situations. That is, situations where each party would be considered a serviceman if he dealt directly with the ultimate user. Some examples are where a person wishing to have a special order printing job does not deal with the printer directly, but with a retailer who sends all his printing orders to a separate firm. Another exampl

arises when a party wishes to have some film developed, and he goes to a party who handles the transaction, but does not actually perform the developing himself. In these and other similar situations, the Department has defined the transfer of property to be the final transfer, and the tax base will be whatever the printer charges the retailer, or the film developer charges the retailer.

The serviceman dealing directly with the ultimate user will be the serviceman who must pay the tax. The other sub-servicemen will be considered suppliers of a serviceman and must collect the tax and remit to the State.

Hotel Operators' Occupation Tax

This is a new tax upon the gross rentals from rooms rented as living quarters, sleeping or housekeeping accommodations. It is imposed upon the operator, but may be passed on to the guest. The effective date of the tax in August, 1961 and the rate is 3%.

Exceptions. The tax does not apply to a permanent resident. A permanent resident has been defined as a person who occupies or has the right to occupy a room for at least thirty consecutive days. This tax does not apply to meeting or banquet rooms when they are rented by a hotel or motel.

(Continued from page 51)

Internal Revenue Code as it is to correct such abuses. Let us hope that Congress, when it reconvenes, takes steps to create incentives for U. S. businesses to go abroad rather than to put a damper on foreign investment through punitive tax legislation under the misguided belief that it is helping with the U. S. balance of payments or that such legislation is needed to prevent tax "abuses" in the foreign investment area.

Conducted by the Committee on Local Practitioners of the Illinois Society of Certified Public Accountants

Comments and Ideas

Originally Ideas for Accountants

"RULES OF PROFESSIONAL CONDUCT"

Recently our Society amended article 9 of our by-laws on "Rules of Professional Conduct." These amendments became effective May 28th, 1961. In a recent discussion with a fellow suburban practitioner, we were both somewhat concerned upon realizing that we would have to discontinue the use of "And Company" after our name unless we had a partner under new Rule 9.3.2. Inconsistent with this rule is rule 9.3.3., "Practice in member's name," whereunder it is stated that "the name of a *former partner* (including deceased) can be retained in the firm name." The reason given for enacting rule 9.3.2. was to prevent the use of a "false" or "ghost" name. There appears to be an inconsistency here, i.e., one rule seems to create a hardship and the other a benefit! Both situations present a problem under U. S. Treasury Department Circular 230; however, proper disclosure to the Intelligence Unit of the facts, usually solves this problem. We further noted that rule 9.1.5. restricts listing our names in classified directories to cities or towns in which we maintain a bona fide office. As small suburban practitioners we have found that we do get occasional phone calls to make audits, prepare tax returns, etc. As a matter of fact, I obtained a large engagement recently due to having my firm name listed in a nearby suburban directory. This is one of the ethical means that we have been able to employ in obtaining new business. As we all know, our practice in the main is built up through referrals, but by the enactment of this rule, our growth and expansion may be restricted.

I feel that this is not what our Society's legislators intended and that these rules should be reviewed. I would like very much to hear the opinions of my fellow society members, especially the small practitioner, concerning these problems. I wonder how many of us are aware of the contents of these amendments?

Jack Mills, C.P.A.
Skokie, Illinois

This section has been revised and replaces the former section styled "Ideas for Accountants." The column is intended to stimulate an exchange of ideas among ALL local practitioners—accountants from the larger firms as well as the sole practitioner. Your comments and opinions are welcome and will be considered for publication.

AS WE GO TO PRESS

COMMENTS AND IDEAS

With this issue a change in format has been instituted in the regular feature of the quarterly formerly known as "Ideas for Accountants." This section will be styled "Comments and Ideas" in the future, with the hope that this change will expand the column's usefulness and encourage authorship of a more interesting and stimulating flow of material from local practitioners. As the title of the section implies, we hope to include material in the future that might be considered to be "letters to the editor" or "shoptalk." Both the editor and members of the Local Practitioners Committee welcome your contributions.

NEW AICPA RESEARCH PROJECTS

Three new projects have been added to the agenda of the Accounting Research Division of the American Institute of Certified Public Accountants.

Accounting for Foreign Operations. A pronouncement on this subject was made by the committee on accounting procedure in ARB No. 4 which subsequently was revised to become Chapter 12, Foreign Operations and Foreign Exchange, of ARB No. 43. A review of the provisions of these pronouncements will be a part of the study.

The study will include an examination of the trends in the nature and objectives of foreign investment by United States corporations with emphasis on their effects on the reporting of the results of that investment. Particular attention will be given to the development of appropriate procedures for the translation of foreign currency balances into dollars, the impact of governmental intervention in the area of exchange rates and currency convertibility, and the problems relating to foreign subsidiaries in the preparation of consolidated and parent-company financial statements.

Intercorporate Investments. A major objective of the study will be to review and amplify a pronouncement of the committee on accounting procedure, ARB No. 51, Consolidated Financial Statements. Particular attention will be given to the problems which are created by the existence of unconsolidated subsidiary companies. The timing of the recognition of earnings of an unconsolidated subsidiary in a consolidated statement will be examined, as well as the extent of supplementary disclosures. In addition, the entire range of problems encountered in the preparation of consolidated financial statements will be studied.

The related parent-company problems will be given special attention. These include the amount at which the investment in subsidiary is included in the assets of the parent corporation, and the recognition of earnings of the subsidiary on the financial statements of the parent.

The problems created by the existence of associated or fifty-percent jointly-owned companies will be given particular attention.

Consideration will also be given to such problems as the accounting for equity securities in uncontrolled affiliates, and holdings of debt securities of other corporations.

This project, and also the study of Accounting for Foreign Operations will be under the specific direction of Samuel R. Hepworth of the University of Michigan.

Price Level Changes. In December, 1947, the committee on accounting procedure issued ARB No. 33, dealing with the subject of depreciation and high costs. The opinion expressed in that bulletin was reaffirmed in Chapter 9, Section A, of ARB No. 43, published in 1953. During the period covered by these two bulletins, the Institute sponsored a Study Group on Business Income which published an independent report, "Changing Concepts of Business Income," in 1952. This report of the Study Group was concerned mainly with the impact of changing prices on business income. A major objective of the new study which has just been initiated is to review these earlier conclusions and recommendations.

This study is proceeding on the assumption that to ignore fluctuations in the value of the dollar in accounting is unrealistic. Under instructions from the Accounting Principles Board, this study will also pay special attention to the use of supplementary statements as a means of disclosure but the study will not be restricted to that aspect of the topic.

This project is being conducted by the staff of the Accounting Research Division of the AICPA with the assistance of Professor Philip W. Bell of Haverford College.

Interested parties may contribute suggestions on these as well as other research topics under consideration by writing Mr. Maurice Moonitz at the AICPA offices, 270 Madison Ave., New York 16, N. Y.

BASIC POSTULATES OF ACCOUNTING

The November issue of "The Journal of Accountancy" included an official release of the AICPA on "Basic Postulates of Accounting." This release is a summary of the study made by Maurice Moonitz under the Institute's expanded research program, and is the first pronouncement resulting from the efforts of this program. Other studies are nearing completion and will be published in the near future. It behooves each CPA to give thoughtful consideration not only to the "Journal" release, but also, and more importantly, to the body of the full report. The fullest development of the potential service which accounting can render to our society will not likely be realized unless all who expect to participate in this development acquaint themselves thoroughly with the results of professional research on both theoretical and practical issues. Copies of Dr. Moonitz' full report may be obtained from the AICPA for $1.50.